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# *Corporate Governance of Banks: An interdisciplinary approach to establish a sound culture*

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*"Rare sono le persone che usano la mente,*
*poche coloro che usano il cuore,*
*uniche coloro che li usano entrambi"*

*"Few are the people using their minds,*
*not many those who use their hearts,*
*and unique those using both"*

*Rita Levi Montalcini*

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## *List of Abbreviations*

| | |
|---|---|
| AIFMD | Alternative Investment Fund Manager Directive |
| AIFMs | Alternative Investment Fund Managers |
| AIFs | Alternative investment funds |
| APR | Approved Persons Regime |
| BCBS | Basel Committee on Banking Supervision |
| BIS | Bank of International Settlement |
| BRRD | Bank Recovery and Resolution Directive |
| CDO | Collateralized debt obligation |
| CDS | credit default swap |
| CEBS | Committee of European Banking Supervisors |
| CEO | Chief Executive Officer |
| CET1 | Common Equity Tier 1 |
| CFA | Chartered Financial Analyst |
| CFO | Chief Financial Officer |
| CMU | Capital Markets Union |
| COB | Conduct of business |
| CRD IV | Capital Requirements Directive IV |
| CRO | Chief Risk Officer |
| CRR | Capital Requirements Regulation |
| CSR | Corporate social responsibility |
| DGS | Deposit Guarantee System |
| DNB | Dutch National Bank (*De Nederlandsche Bank N.V.*). |
| DOL | Department of Labor (US) |
| DSI | Dutch Securities Institute |
| EBA | European Banking Authority |
| ECB | European Central Bank |
| ECJI | European Corporate Governance Institute |
| EDIS | European Deposit Insurance Scheme |
| EEA | European Economic Area |
| EIOPA | European Insurance and Occupational Pensions Authority |
| EMU | European Monetary Union |

| | |
|---|---|
| ESAs | European Supervisory Authorities |
| ESFS | European System of Financial Supervision |
| ESG | environmental, social, and corporate governance |
| ESMA | European Securities and Markets Authority |
| ESRB | European Systemic Risk Board |
| EU | European Union |
| FCA | Financial Conduct Authority |
| FRC | Financial Reporting Council |
| FSA | Financial Services Authority |
| FSB | Financial Stability Board |
| FSF | Financial Stability Forum |
| G30 | Group of Thirty |
| G-SIBs | globally systemically important banks |
| HLEG | High-Level Expert Group |
| IAIS | International Association of Insurance Supervisors |
| INFE | International Network on Financial Education |
| IORP | Institutions for occupational retirement provision |
| IOSCO | International Organization of Securities Commissions |
| ISD | Investment services directive |
| KID | Key investor document |
| KIID | Key investor information document |
| LIBOR | London Interbank Offered Rate |
| MDGs | Millenium Development Goals |
| MiFID | Markets in Financial Instruments Directive |
| MiFIR | Markets in Financial Instruments Regulation |
| NPLs | Non-performing Loans |
| OECD | The Organisation for Economic Co-operation and Development |
| OTC | over-the-counter |
| PEPP | European personal pension product |
| PPI | Payment Protection Insurance |
| PRA | Prudential Regulatory Authority |
| PRI | Principles for Responsible Investment |
| PRIIPs | Packaged retail and insurance-based investment products |
| RAS | Risk Appetite Statement |
| RMI | Risk Management Index |
| SEC | Securities and Exchange Commission |
| SIFIs | Systemically important financial institutions |

| | |
|---|---|
| SM&CR | Senior Manager and Certification Regime |
| SMEs | Small to medium sized enterprise |
| SRB | Single Resolution Board |
| SRD | Shareholders' Rights Directive |
| SREP | Supervisory review and evaluation process |
| SRF | Single Resolution Fund |
| SRI | Socially Responsible Investment |
| SRM | Single Resolution Mechanism |
| SROI | Social return on the investment |
| SSM | Single Supervisory Mechanism |
| TEG | Technical Expert Group on Sustainable Finance |
| UCITS | Undertakings for collective investment in transferable securities |
| UNEP FI | United Nations Environment Programme and the global financial sector |

# Introduction

The 2008 financial crisis shed light on the immoral conducts, reckless practices and the widespread short-sightedness that affected the entire financial sector. As a result, a wave of legislative reforms hit all financial institutions, especially in relation to capital and liquidity requirements, but also to corporate governance and investor protection regulation in general.

However, inadequate rules, bad corporate governance and a lack of public enforcement cannot fully explain malpractice. On the contrary, the roots of misconduct cannot be completely understood without a prior analysis of the various cultural and psychological dynamics underlying financial operators' practices. Therefore, a new approach is required, in which legal and economic studies intersect with sociology, psychology, anthropology and neuroscience, to get a better understanding of the main determinants of human behaviour. We cannot expect banking institutions – that are run by human beings – to be 'fixed' without investigating or even considering why people deviate from lawful conduct rules. Moreover, as the nature of the determinants of misconduct is behavioural and cultural, and since regulation *per se* cannot be expected to promote good corporate culture, in this thesis I argue that boards and supervisors should be primarily responsible for the enactment of a cultural change.

The thesis consists of two main parts. In the first part, I analyse bank governance institutional framework based on the international and European agenda. In the second part, I explain why there is a need to reinterpret corporate governance principles and practices in the light of sociological and behavioural sciences, in order both to avoid financial misbehaviour and induce banks to take part of the path towards sustainable development in the light of the UN 17 Sustainable Development Goals. In particular, I analyse traditional corporate governance issues, such as board composition requirements, leadership, compliance, risk management and executive compensation in the light of studies by researchers in behavioural economics, organizational culture and neuroscience. Moreover, I analyse how

supervisors and institutional investors could play an active role in supporting the board in the establishment of a new cultural model. Finally, I describe the recent initiatives on sustainable finance, which are undoubtedly going to accelerate the transition to a long-term stakeholder-oriented approach to economic growth.

# PART I

# CORPORATE GOVERNANCE OF BANKS

# Chapter I

## The Role of Corporate Governance in Banking Crises

1.1 The origins of Corporate Governance: A Brief Overview. – 1.2 Corporate Governance of Banks: Why are they special? – 1.3 The Role of Corporate Governance in the Financial Crisis: does it really matter?

### 1.1 The origins of Corporate Governance: A Brief Overview

Although research on corporate governance is a relatively recent phenomenon, its birth can be traced back to the foundation of the East India Company and other major chartered companies established between the XVI and XVII centuries.[1] Adam Smith was the first to theorize that conflicts of interests between owners and managers limit the efficient management of corporations. In particular, he claimed that:

> "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company." [2]

The term 'corporate governance',[3] began to be used with a broader meaning – as the study of the balance of powers between shareholders, directors and officers – in the US in the XX century, in concurrency with the foundation of the first public companies. In these large corporations, the separation between ownership and

---

1 Brian, R Cheffins, 'The History of Corporate Governance', ECGI - Law Working Paper No. 184/2012 available at https://ssrn.com/abstract=1975404, 4 accessed 20 September 2018.

2 Adam Smith, *An inquiry into the nature and causes of the wealth of nations* 606–07 (1776), 2005 edition, Penn State Press, Book 5, Ch. 1.3.1.2..

3 The term derives from an analogy with the governance of nations and local communities. *See* Marco Becht & Patrick Bolton & Ailsa Roell, 'Corporate governance and control', in G M Constantinides & M Harris & R M Stulz (eds), *Handbook of the Economics of Finance*, Elsevier 2003, 1-109.

control, caused by a highly fragmented ownership, led to the need to strengthen board monitoring duties and the system of control in general, in order to contrast the increasing power of managers.[4] Moving forward to the present era, in the mid-1970s, the federal Securities and Exchange Commission (S.E.C.) put corporate governance on the official reform agenda after the discovery of illicit behaviours carried out in large companies, due to the alleged lack of efficient monitoring activities by the board.[5]

Corporate governance gained global interest in the 1990s. In 1991, the Financial Reporting Council, the London Stock Exchange and the Accountancy profession constituted a committee with the task of analysing corporate governance in the UK and, as a result, published the 'Report Of The Committee On The Financial Aspects Of Corporate Governance', better known as the 'Cadbury Report'. The report defined corporate governance as "the system by which companies are directed and controlled"[6] and set the main responsibilities of boards, directors, auditors and shareholders by formalizing widely accepted practices.

This new concept of corporate governance[7] was fiercely rejected – as still too narrow and limitative – by other economists and organizational theorists such as Mitroff,[8] Williamson,[9] Freeman[10], Donalson and Preston,[11] who supported the so-called 'stakeholder theory of corporation', where stakeholders include employees, customers, suppliers and the society at large. In line with this view, in 1999 the OECD definitively granted international recognition to corporate governance, by publishing the 'Principles of Corporate Governance' (hereinafter, the "OECD Principles"), where it stated that corporate governance

> "involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides

4 The concept was analysed in the studies conducted by Berle and Means on the new form of capitalism born in US. See Adolf Berle & Gardiner Means G, *The Modern Corporation and Private Property*, Macmillan, 1932.
5 *See* Cheffins, n 1.
6 Adrian Cadbury, 'Report of the Committee on the Financial Aspects of Corporate Governance' (1993) (Cadbury Report), §2.5.
7 The approach, widely used during the first decades of development of corporate governance studies, limited the subject of corporate governance to the mechanisms that allow shareholders to monitor managers' operations, and therefore to the relationships between shareholders, managers and directors. *See*, *inter alia*, Andrei Shleifer & Robert W Vishny, 'A Survey of Corporate Governance', Journal of Finance (1997), 52, 737.
8 Ian I Mitroff, *Stakeholders of the organizational mind*, Jossey-Bass Publisher, 1983.
9 Oliver E. Williamson, *The Economic Institutions of Capitalism*, Free Press, 1985.
10 Robert Edward Freeman, *Strategic Management: A Stakeholder Approach*', Pitman Publishing, 1984.
11 Thomas Donaldson & Lee E. Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications', Academy of Management Review, 1995, 20(1), 70–71.

the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders, and should facilitate effective monitoring"[12]

By issuing the principles, the OECD provided a globally recognized benchmark for assessing and improving corporate governance. In this thesis, I will refer to "corporate governance" in its broader meaning, which comprises both internal and external governance factors.[13]

## 1.2 Corporate Governance of Banks: Why are they special?

The debate on the importance of a good corporate governance in banking and financial institutions in general started in the 1980s,[14] and flourished in the 1990s, following the Asian Crisis. Scholars conducted researches trying to identify the roots of the crisis, and finally laid the blame on poor corporate governance, especially on the inefficiency of relationship-based capitalistic systems[15] and the weak protection of minority shareholders.[16]

In 1999, based on the belief that an effective corporate governance of banking institutions is an indispensable condition for financial stability, the Basel Committee on Financial Supervision (BCBS), modelled after the OECD Principles, issued the guidance 'Enhancing Corporate Governance for Banking Organizations' to encourage national supervisors to promote "…the adoption of sound corporate

12 Organisation for Economic Co-operation and Development (OECD), 'OECD Principles of Corporate Governance', 1999, 9. The definition did not change in the last revised version (2015).
13 For a review on corporate governance studies, see Shleifer & Vishny, n 7, 737-783.
14 Specifically, the first contributions were published by Douglas W Diamond ('Financial Intermediation and Delegated Monitoring', The Review of Economic Studies (1984), 51(3), 393-414), and Eugene F Fama ('What's different about banks?', Journal of Monetary economics (1985), 15(1), 29).
15 Raghuram G Rajan and Luigi Zingales, 'Which Capitalism? Lessons from the East Asian Crisis', Journal of Applied Corporate Finance (1998), 11(3).
16 According to Jonhson et al., the low protection of minority shareholders' rights allowed the currency depreciation and the consequent crashing of the Asian markets. *See* Simon Johnson, Peter Boone, Alasdair Breach and Eric Friedman, 'Corporate Governance in the Asian Financial Crisis', Journal of Financial Economics (2000), 58, 1, 2.

governance practices by banking organisations in their countries".[17] The BCBS provided a definition of corporate governance of banks, as "…the manner in which the business and affairs of banks are governed by their boards of directors and senior management" in the way they: "set corporate objectives; operate the bank's business on a day-to-day basis; meet the obligation of accountability to their shareholders and take into account the interests of other recognised stakeholders; align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and protect the interests of depositors".[18] By highlighting the importance of protecting depositors' interests, of including supervisors and government among banks' stakeholders, as well as of the necessary compliance with a stricter and richer set of rules,[19] the guidance also anticipated some of the common features – discussed in academic studies in the following years – which distinguish banking from non-financial institutions. However, the BCBS did not ignore the inefficiency of a one-size-fits-all approach, based on the consideration that there are "…significant differences in the legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management".[20]

Starting from the 2000s, not only listed banks and even non-listed institutions increasingly highlighted the importance of establishing a sound corporate governance,[21] but academics too conducted several analyses on the features of corporate governance in banking institutions.[22] A second wave of literature was produced starting from the second year following the 2007 financial crisis, after the global recognition of the failure of corporate governance in the prevention of the financial turmoil and of the need to reform it in a substantive way.[23]

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17 Basel Committee on Banking Supervision (BCBS), Enhancing Corporate Governance for banking organizations (1999), § 6.
18 *Id*, § 10.
19 *Id*, § 9.
20 *Id*, § 5.
21 Peter O Mülbert, 'Corporate Governance of Banks after the Financial Crisis - Theory, Evidence, Reforms', ECGI Law Working paper Series, ECGI - Law Working Paper No. 130/2009, available at https://ssrn.com/abstract=1448118, 5, accessed 30 September 2018.
22 For a review of the empirical and theoretical literature on the governance of banks before the 2007 financial crisis, *see* Mülbert, n 21, note 15 e 16.
23 At the beginning, studies on the financial crisis did not consider corporate governance as one of the main determinants of the crisis. *See* Mülbert, n 21, 7-8.

Given the strong impact financial institutions have on economic development and growth,[24] several studies tried to identify the main characteristics that mark out credit institutions' governance from other institutions. In particular, based on previous contributions on the subject,[25] we can distinguish among four traits: (a) liquidity risk and high leverage; (b) balance sheet opaqueness; (c) high interconnection; and (d) heavy regulation and supervision. As a result of these aspects, banks are subject to high reputational and systemic risks[26], as well as to specific agency costs (e).

(a) High leverage and liquidity risk

Liquidity risks derive from the maturity mismatch between assets and liabilities. For their nature, banks heavily rely on the so-called transformation of maturities, which means that their business model consists in borrowing short and lending long.[27] In other words, banks are highly leveraged firms, since they rely heavily on debt instead of equity.[28] This exposes banks to the need for continuous access to liquidity for their own survival, and explains the wave of prudential regulation concerning banks' liquidity risk and management.[29] This comes as no surprise also considering that, liabilities being for the most part made up by deposits, a bank run poses high risks in terms of financial stability.

(b) Balance sheet opaqueness

Banks, like pension funds and insurance companies,[30] are famous for being less transparent than other firms. This opaqueness – which leads to information

24 Levine analysed the positive link between the functioning of financial institutions and economic development. *See* Ross Levine, 'Financial development and economic growth: Views and agenda', Journal of Economic Literature (1997), 35, 688-726.
25 I especially refer to papers by Mülbert, n 21, Macey & O'Hara, n 25, 91–107, Klaus J Hopt, 'Better Governance of Financial Institutions' (2013), ECGI Law Working Paper No 207/2013, available at https://ssrn.com/abstract=2212198, accessed 30 September 2018.
26 Hopt, n 25.
27 Mülbert, n 21, 10. As a consequence, public trust is essential for banking system, *see* Hopt, n 25, Armour et al., n 27.
28 Macey and O'Hara, n 25, 91-107.
29 At the international level, I refer in particular to the Basel III Framework by the Basel Committee on Banking Supervision; at the EU level, we refer to CRD IV package, comprising Directive 2013/36/EU and Regulation (EU) N° 575/2013.
30 Donald Morgan, 'Rating banks: Risk and uncertainty in an opaque industry', American Economic Review (2002), 92, 874–888; Gerard Caprio & Jr Ross Levine, 'Corporate governance in finance:

asymmetries between insiders and outsiders,[31] and was one of the major causes of the 2007 financial crisis –[32] is mostly due to the complexity of bank loans (their quality is not readily observable) and of the financial products banks invest in (such as CDOs). This allows banks to change the risk composition of their assets more quickly without taking new positions.[33]

(c) High interconnection

Credit institutions are usually tied one to each other because of the nature of their activities, and relate especially on the interbank, OTC and the foreign exchange markets. Therefore, a crisis hitting one bank can affect other banks and, if contagion is severe, the entire financial system.[34] This is why banks have been often described by using expressions such as "too big to fail", "too connected to fail" or "too risk-correlated to fail".[35]

(d) Heavy regulation and supervision

Because of the special problems explained above – high liquidity risk, opaqueness and interconnection –, as well as their systemic importance, banks are subject to stronger regulatory intervention and supervisory control.[36] Consequently, even corporate governance is differently regulated and heavily monitored in credit institutions.

This may have both positive and negative effects for banks. On the one hand, banking regulation may limit banks' exposure to risks and set standards for sound liquidity management.[37] On the other, regulators and governments may discourage

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Concepts and international observations', in R E Litan, M Pomerleano, and V. Sundararajan (eds), *Financial Sector Governance: The Roles of the Public and Private Sectors*, The Brookings Institution, 2002, 17-50.
31 Caprio & Levine, n 30, 17-50.
32 Mülbert, n 21, 11.
33 Mülbert, n 21; and Caprio & Levine, n 30, 17-50.
34 Mülbert, n 21.
35 John C Coffee Jr, 'The political economy of Dodd-Frank: Why financial reform tends to be frustrated and systemic risk perpetuated', Cornell L. Rev. (2012), 97, 1019; Steven L Schwarcz, 'Systemic Risk', Georgetown Law Journal (2008), 97, 193, 202 et seq..
36 Mülbert, n 21.
37 Mülbert, n 21.

competition by imposing ownership restrictions,[38] limit the power of markets to discipline the banks, its owners and managers,[39] or even pursue their own interests instead of social welfare.[40]

(e) Agency costs

Due to their specialness, banks suffer from specific corporate governance issues from a principal-agency point of view.

As a consequence of bank opaqueness and heavy banking regulation, competitive forces – which generally help firms and shareholders to limit and discipline managers' behaviour through the threat of takeovers – are rather weak in banks compared to non financial firms.[41] Moreover, government regulatory restrictions – especially those concerning ownership concentration and share purchase – though at times being inadequate at limiting family control of banks, actually offered family-controlled banks increased safeguards from takeovers.[42]

In banks, the mandatory board orientation towards creditors' interests, and therefore the conflict of interests between shareholders – who pursue profit maximization – and creditors (bondholders and depositors) – who are only interested in the bank's ability to pay their debt – becomes an additional component to traditional principal-agency conflicts (majority/controlling vs. minority/dispersed shareholders and shareholders vs. managers).[43] Thus, a solution aimed at maximising shareholder value is neither appropriate nor sufficient.[44] Moreover, the information asymmetries between insiders – shareholders, managers and directors – and outsiders – debtholders and other stakeholders – extend the

38 Stephen Prowse, 'Corporate control in commercial banks', Journal of Financial Research (1997), 20, 509–527; Macey & O'Hara, n 25, 91–107.
39 Penny Ciancanelli & José Antonio Reyes-Gonzalez, 'Corporate Governance in Banking: A Conceptual Framework' (2000), available at https://ssrn.com/abstract=253714, accessed 5 October 2018.
40 Arnoud Boot & Anjan Thakor, 'Self interested bank regulation', American Economic Review (1993), 83, 206–212; James Buchanan and Gordon Tullock, *The Calculus of Consent*, University of Michigan Press, 1962; and Alexander Hamilton & James Madison & John Jay, 'Federalist Papers' (1778), in C Rossiter (ed), New American Library, 1961.
41 Ross E Levine, 'The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence', World Bank Policy Research Working Paper No. 3404/2004, available at https://ssrn.com/abstract=625281, accessed 10 October 2018; Prowse, n 38; Ciancanelli, n 39.
42 Levine, n 41.
43 Hopt, n 25, 8; Macey & O'Hara, n 25, 98; Mülbert, n 21, 15.
44 Andy Mullineux, 'The corporate governance of banks', Journal of Financial regulation and Compliance (2006), 14, 4, 375-382.

opaqueness characterizing banks' balance sheets to their entire operative structure.[45] This creates distortions in the incentive remuneration schemes, as the opacity of directors' compensation packages tempts them to pursue short-term results, thereby accepting excessive risk-taking at the expense of the long-run soundness of the bank.[46] Opaqueness also allows insiders to exploit outsiders, as occurred especially in most developing countries where a few families held the controlling shareholding of most banks, which lent money incautiously to bank insiders.[47]

According to some authors, regulators and supervisors should therefore be considered as stakeholders of the bank.[48] Critically, Hopt argues that it makes little sense thinking about regulators and supervisors as actors whose interests should be protected.[49] According to the author, their intervention is external, as it would respond to the need to improve corporate governance for the maintenance of financial stability. However, I disagree with Hopt's opinion, since, based on another critical approach,[50] I doubt that the interests of regulators and society as a whole are automatically aligned. Owing to this higher number of parties having a stake in an institution's activity, bank boards are burdened with extended responsibilities, and for this reason supervisors and regulators are now setting special suitability requirements for bank board members (see Section 2.2.3.2).

Finally, moral hazard is exacerbated also by deposit insurance, since this prevents shareholders from ever internalizing the losses from risky investments.[51] Indeed, with the aim to prevent the systemic risks of bank runs, many legislators have provided safety nets – i.e. the lender of last resort and the deposit insurance components – that not only have pushed shareholders and managers to engage in excessive risk-taking[52], since depositors are less incentivised to monitor banks, but have also contributed to producing banks with very low capital-asset ratios.[53]

45 Levine, n 41, 7.
46 Hopt, n 25, 14; Levine, n 41, 7; Macey & O'Hara, n 25, 98.
47 Caprio & Levine, n 30, 17-50.
48 Renee B Adams & Hamid Mehran, 'Is Corporate Governance Different for Bank Holding Companies?', Economic Policy Review (2003), 9, 1, available at SSRN: https://ssrn.com/abstract=795584, accessed 10 October 2018.
49 Hopt, n 25.
50 *See* note 40, and Levine, n 41.
51 *See* Guido Ferrarini and Maria Cristina Ungureanu, 'Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks', Vanderbilt Law Review (2011), 62, 2, 440.
52 Macey & O'Hara, n 25, 91–107; Vasile Cocris & Maria Cristina Ungureanu, 'Why are Banks Special? An Approach from the Corporate Governance Perspective', Scientific Annals - Al.I.Cuza University of Iasi, Economics Series (2007), 55-66.
53 Levine, n 41.

## 1.3 The Role of Corporate Governance in the Financial Crisis: does it really matter?

Following the 2008 financial crisis, regulators, supervisors and the financial community in general started to question the efficacy of corporate governance arrangements in preventing misconduct in banks and in ensuring financial stability. Most of the official policy documents published after the financial turmoil argued that inefficient corporate governance arrangements promoted the illicit behaviours that ultimately led to the outbreak of the crisis. The OECD, for instance, concludes that the "the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance weaknesses" and, in particular, argued that the malfunctioning risk management, distorted incentive schemes which encouraged high risk-taking, and the lack of proper competence and expertise on the part of directors, led to a weak oversight by the board.[54] This conviction was largely shared by financial authorities and policy makers.[55] The Larosière report[56] and the high-level Group on Financial Supervision in the EU highlighted that corporate governance failures – in addition to macroeconomic factors, and the role played by credit rating agencies and supervisors – indirectly contributed to the start of the crisis. Based on the same premises, a year later the EU Commission in a Green paper stated that many deficiencies concerning the role of the board of directors and shareholders, and the performance of the risk management, supervision and auditing activities played a decisive role in the collapse of the financial institutions.[57] The Commission, in particular, questioned the adequacy of traditional corporate governance principles in the financial services sector, as too broad and lax to ensure an effective implementation in such a complex sector suffering from unique agency-costs issues, especially in relation to the different levels of risk appetite of shareholders and creditors (depositors, life insurance policy holders, beneficiaries of

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54 Grant Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis', OECD Journal of Financial Market Trends (2009), 1, 61.

55 *See* EBA, 'EBA Guidelines on Internal Governance 3', 2011; Associacion of Chartered Certified Accountants, 'Corporate Governance and the Credit Crunch', 2008, 4, available at https://www.accaglobal.com/content/dam/acca/global/PDF-technical/corporate-governance/cg_cc.pdf, accessed 20 October 2018; G20 Working Group 1, 'Enhancing Sound Regulation and Strengthening Transparency', 2009, available at https://www.gfintegrity.org/storage/gfip/documents/g20%20working%20group%201%20report.pdf, accessed 20 October 2018.

56 *See* the 'Report of the High-Level Group on Financial Supervision in the EU', chaired by Jacques de Larosière, 2009, 7-11.

57 EU Commission, Green Paper, Corporate governance in financial institutions and remuneration policies, Bruxelles, 284 final, 2010.

pension schemes).[58] Based on the weaknesses and deficiencies highlighted in the Green paper, the Commission proposed – and later implemented – significant reforms concerning the composition and functioning of the board of directors, the risk management function, the role of external auditors and supervisory authorities, and the remuneration of the directors of financial listed companies (see Section1.2.3).

Scholars too attempted to clarify the major deficiencies of corporate governance as evidenced by the financial crisis. Hopt, for example, identified five major causes: (i) failures in risk management and internal control, (ii) incompetence and inadequate profile of board members and senior managers, (iii) complex and opaque corporate and bank structures, (iv) wrong incentives, (v) and low levels of disclosure and transparency.[59]

However, these arguments have been challenged by empirical studies that showed how corporate governance played no significant role during the crisis.[60] For instance, Beltratti and Stulz,[61] by analysing a sample of ninety-eight large banks across the world, found that banks with better governance did not perform better than other banks during the crisis. On the contrary, they found that banks with more pro-shareholder boards performed worse than others. In another study, Fahlenbrach and Stulz found that banks where CEO incentives were better aligned with the interests of shareholders "had worse stock returns and a worse return on equity.[62]

From these findings it emerges that 'traditional' corporate governance arrangements – which tend to align the interests of shareholders and managers – played no valuable role during the crisis. On the contrary, they led managers to take higher risks. As I noticed in the previous section, this can be reasonably explained by considering that in the financial services industry the conflict of interests between shareholders - seeking high profitability and therefore prone to higher risks - and creditors – strongly risk-adverse – challenges the conventional wisdom

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58 *Id.*, 4-6.
59 Hopt, n 25, 10-14.
60 *See* Adams, n 349, 14-15.
61 Andrea Beltratti & René M Stulz, 'The Credit Crisis Around the Globe: Why Did Some Banks Perform Better?', Charles A Dice Center Working Paper No. 2010-5; Fisher College of Business Working Paper No. 2010-03-005, available at https://ssrn.com/abstract=1572407 or http://dx.doi.org/10.2139/ssrn.1572407, accessed 15 October 2018.
62 Rüdiger Fahlenbrach & René M Stulz, 'Bank CEO Incentives and the Credit Crisis', Journal of Financial Economics (2010), 99, 1, 11.

that banks with shareholder-friendly boards have a better governance. Moreover, it was reasonably highlighted that "in financial intermediaries a major part of the losses are externalized to stakeholders, while gains are fully internalized by shareholders and managers".[63] Bank creditors, unlike the creditors of other firms, are dispersed, suffer from a lack of oversight rights and therefore have no defensive tools against shareholder and manager opportunism.[64]

We may conclude that bad corporate governance was not the main determinant of the crisis, but only on the premise that corporate governance in banks does not differ from that of non-financial firms. If we consider the specific governance problems afflicting banks and other financial institutions, we notice that the application of traditional corporate governance best practices to banks by policy makers and financial industry participants revealed itself to be incautious.[65] The so-called 'good corporate governance', in other words, turned out to be a wrong governance when applied to banking institutions. Banks' complexity and opaqueness, as well as their high leverage, the weight of moral hazard (increased by government safety nets) and the conflicts among shareholders and a significant number of stakeholders, suggest banks suffer from unique corporate governance issues and, therefore, should be subject to a special and tighter regulation compared to non-financial firms. As Christine Lagarde, Managing Director of the International Monetary Fund, asserted in her well-known speech at the New York Fed "… trading on time, custodian of savings, merchant of trust bound by fiduciary duty, and beneficiary of state implied guarantee makes banks indeed very special. In today's world, the financial industry wields immense power over societies, economies and people. With this power comes the responsibility to uphold the highest ethical standards"[66].

It should be added that capital adequacy and other financial performance indicators played a significant role during the crisis. Beltratti and Stulz, for instance, found evidence that worse-performing banks before the crisis also did worse during and after the crisis, and conclude that the levels of financial returns, Tier 1 capital

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63 *See* Guido Ferrarini, 'Understanding the Role of Corporate Governance in Financial Institutions: A Research Agenda', European Corporate Governance Institute (ECGI) - Law Working Paper No. 347/2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2925721, accessed 20 October 2018, 8.
64 Armour et al., n 27.
65 *Id.*
66 Speech, Christine Lagarde, 'The Role of Personal Accountability in Reforming Culture and Behavior in the Financial Services Industry', New York Fed, November 5, 2015.

ratio and deposit amounts were the most relevant factors discriminating worst- and best-performing banks, as confirmed by other empirical studies.[67]

In conclusion, regardless of the actual role played by corporate governance in the crisis, there is no doubt that reform was needed in order to face the deficiencies detected. Moreover, supervisors and regulators have to play an essential role in reducing risk propensity and obliging banks to maintain capital above a certain level in order to ensure financial stability.[68] However, since, as I discuss in Part II, the financial scandals were ultimately caused by a widespread dysfunctional culture in the financial sector, and given that regulation *per se* cannot be expected to promote good corporate culture, I argue that the role of corporate governance should be enhanced so as to reinforce sustainable conduct within financial institutions.

67 *See* Asli Demirguc-Kunt, Enrica Detragiache & Ouarda Merrouche, 'Bank Capital: Lessons from the Financial Crisis', Policy Working Paper 5473/2010, World Bank, available at https://www.imf.org/external/pubs/ft/wp/2010/wp10286.pdf, accessed 20 October 2018; Allen N Berger and Christa H S Bouwman, 'Bank Capital, Survival and Performance around Financial Crises', Working Paper (2009).

68 Lawrence White, 'Corporate Governance and Prudential Regulation of Banks: Is There Any Connection?', in James R Barth, Chen Lin & Clas Wihlborg (eds), *Research Handbook for Banking and Governance*, Elgar Publishing, 2011,available at https://ssrn.com/abstract=1836716, accessed 21 October 2018, note 2, 344.

## Chapter II

## Global Principles and European Banking Union Regulatory Framework

1.2.1 The Global Principles by the Basel Committee on Banking Supervision and the Financial Stability Board – 1.2.2 The European Banking Union and EU recent reforms. – 1.2.3 Regulating Governance in the European Banking Union. - 1.2.3.1 Regulatory and Supervisory Approach. - 1.2.3.2 The EU Regulatory Framework – 1.2.3.2.1 CRD IV. - 1.2.3.2.2 EBA Guidelines. - 1.2.3.2.3 ECB regulation.

Several significant corporate governance reforms have been enacted over the last two decades. In particular, a first wave of reforms took place at the beginning of the 2000s, immediately after the Enron bankruptcy and other corporate scandals. These reforms concerned in particular the role of auditors and executive compensations for both financial and non-financial corporations. The great financial crisis triggered the second wave of reforms mainly addressed to financial institutions, which implied significant intervention not only in terms of prudential regulation and crisis management, but also with reference to compensation practices, board composition and risk management functions.

### 1.2.1 The Global Principles by the Basel Committee on Banking Supervision and the Financial Stability Board

Since the crisis, establishing a sound financial system has been regulators' highest priority. As a consequence, the banking sector is still today one of the most developed areas of reform. At the present time, the Basel III standards, published by the Basel Committee on Banking Supervision (BCBS) set out a global framework and provide a foundation for a resilient banking system, by requiring banks to fulfil a series of requirements in relation to capital, leverage and liquidity.[69] In particular, Basel III reforms aim at: (a) improving the quality of bank regulatory capital by

69 BCBS, 'Basel III: A global regulatory framework for more resilient banks and banking systems', December 2010 (later revised in June 2011).

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placing a greater focus on Common Equity Tier 1 (CET1) capital; (b) increasing the level of capital requirements; (c) improving risk measurement and management; (d) limiting systemic risks; and (e) specifying a minimum leverage ratio requirement to constrain excess leverage. Furthermore, the BCBS have introduced an international framework for mitigating excessive liquidity transformation, through the Liquidity Coverage Ratio and Net Stable Funding Ratio. [70]

Many other policy documents specifically addressed corporate governance issues of banks. In 1999, the BCBS, based on the OECD's Principles of Corporate Governance published the same year, issued its first corporate governance guidance – 'Enhancing Corporate Governance for Banking Organizations' –, later revised in February 2006, "to assist banking supervisors in promoting the adoption of sound corporate governance practices by banking organizations in their countries[71]". In October 2010, the BCBS issued a new guidance, the 'Principles for enhancing Corporate Governance', later revised in 2015 under the name 'Corporate governance principles for Banks' (BCBS Principles) in which it establishes thirteen high-level principles, in order to assist not only banking supervisors, but also banking organizations worldwide with the implementation of sound practices. The principles should be implemented by any kind of banking organization, regardless of size or ownership structure. However, the BCBS Principles specify that "the implementation of these principles should be commensurate with the size, complexity, structure, economic significance, risk profile and business model of the bank and the group (if any) to which it belongs".[72]

According to the new guidelines, a bank's board, among its other duties, should[73] (1) carry out its overall responsibilities for the bank, such as the establishment of the bank's organizational structure, risk governance framework, its corporate culture and values, as well as monitoring senior management on the implementation of the bank's strategy; (2) have members with appropriate experience in financial activities, professionalism and personal integrity, favouring qualified non-executive members in order to enhance board independency and objectivity; (3) define appropriate governance practices, for example by establishing specialized board committees and setting a formal conflicts of interest policy (paying

70 *Id.*
71 *See* BCBS, 'Enhancing Corporate Governance for Banking Organizations', September 1999
72 BCBS, 'Corporate governance principles for Banks', 2015, 6.
73 *Id.*, Principles 1,2,3 and 9.

close attention to the presence of controlling shareholders); and (4) actively supervise the compensation system and review it to ensure its correct operation (in particular, it should be aligned with prudent risk-taking). As to senior management, this should ensure that a bank's activities are consistent with its business strategy, risk tolerance/appetite and policies approved by the board[74]. A bank should also have an effective internal controls system and a risk management function responsible for identifying, measuring, controlling or mitigating, and reporting on risk exposures; a Chief Risk Officer or an equivalent should be appointed[75]. In a group structure, the board and senior management should have a good knowledge and understanding of the bank's structure and the risks that this structure poses[76]. Specific principles are also set out in relation to compliance, internal audit, compensation, disclosure and transparency, and the role of supervisors.[77]

In relation to remuneration, the BSBC refers to the Financial Stability Board (FSB) 'Principles for Sound Compensation Practices' (FSB Principles) and their Implementation Standards, which apply to all significant financial institutions.[78] These call for an effective governance of compensation, and supervisory oversight and engagement by stakeholders, but also require financial institutions to align compensation practices to prudent-risk taking, which means that they should be adjusted for all types of risk and be symmetric with risk outcomes. Deferred compensation should make compensation pay-out schedules sensitive to the time horizon of risks. Moreover, for senior executives, as for other key employees, a substantial portion of variable compensation (from 40 to 60 per cent), should be payable under deferral arrangements over a period of not less than three years, in proportion to the level of seniority and/or responsibility, and, in order to provide an incentive for long-term value creation, at least 50 per cent of variable compensation should be awarded in shares or share-linked instruments.

With reference to bonuses, the FSB considers 'guaranteed bonuses' not consistent with sound management or the pay-for-performance principle.

74 *Id*, Principle 4
75 *Id*, Principle 6-7.
76 *Id.*, Principle 5.
77 *Id*, Principles 9-13.
78 *See* Financial Stability Forum, 'FSF Principles for Sound Compensation Practices', April 2009; and Financial Stability Board (FSB), 'FSB Principles for Sound Compensation Practices. Implementation Standards', September 2009.

Accordingly, clawback mechanisms should operate in case of negative performance of the firm during the vesting period.

### 1.2.2 The European Banking Union and EU recent reforms

In October 2008, the EU Commission Chairman José Manuel Barroso chose Jacques de Larosière to chair a group of experts to give advice on reforms to be enacted in the EU in relation to financial regulation and supervision. The final report, published in 2009, discussed a number of key areas in need of regulatory reforms: stronger macroeconomic policy and macro-prudential analysis, reform of the Basel 2 framework, credit rating agencies' accounting, insurance, sanctions/supervisory powers, parallel banking system, securitized products/derivatives markets, and investment funds. Building on the report's recommendations, from that moment on the EU Commission started to enact a series of significant reforming interventions that are still today shaping the entire European financial system.

In 2010, the European System of Financial Supervision (ESFS) was established, covering both micro-prudential and macro-prudential supervision. In relation to micro-prudential supervision, three European Supervisory Authorities (ESAs) were founded: the European Banking Authority (EBA),[79] the European Insurance and Occupational Pensions Authority (EIOPA),[80] and the European Securities and Markets Authority (ESMA).[81] With regard to macro-prudential supervision, the European Systemic Risk Board (ESRB) has been established.[82] The ESFS includes also representatives of supervisory authorities from each Member State, and cooperates with many other financial authorities.

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79 Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC

80 Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC.

81 Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

82 Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board.

To summarize, the ESFS comprises the ESRB, the ESAs and the Member States' competent supervisory authorities. The main objective of the ESFS is to ensure the adequate implementation of the rules enacted in the financial sector in order to protect consumers, limit the distress of individual financial institutions and thus preserve financial stability in general.

However, the simple coordination activity among supervisory authorities was not sufficient to prevent the fragmentation of the European financial market. Consequently, in 2012 the Commission proposed the creation of a EU Banking Union aimed at further integrating the banking sector. Following the European Commission roadmap,[83] the EU institutions agreed to create a banking union based on three pillars: the single supervisory mechanism (SSM),[84] a single resolution mechanism (SRM)[85] and a European deposit insurance Scheme (EDIS). The first two pillars of the banking union have been already fully implemented, which means that all EU banks are supervised according to the same standards within the framework of the SSM, that the most significant banks are centrally supervised by the European Central Bank (ECB) and that in case of failure, banks can be centrally resolved following the same standards within the SRM, which is backed by a Single Resolution Fund (SRF). However, the third pillar – aiming at establishing a common system for deposit protection – has still to be implemented. Moreover, in October 2017 the European Commission urged the EU Parliament and the Council to quickly adopt further measures in order to complete the Banking Union and improve risk management within the banking sector.[86] In this regard, in February 2018, the Commission published a comprehensive package fostering financial stability in the EU by focusing on a mix of complementary policy actions in four areas as set out in the ECOFIN Action Plan on NPLs: (i) bank supervision and

83 European Commission, Communication from the Commission to the European Parliament and the Council, 'A Roadmap towards a Banking Union', COM/2012/0510 final.

84 *See* Council Regulation (EU) No 1024/2013 of 15 October 2013 which established the SSM and conferred specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions (SSM regulation).

85 *See* Regulation (Eu) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund.

86 European Commission, Communication to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on completing the Banking Union, COM(2017) 592 final.

regulation, (ii) national restructuring, insolvency and debt recovery frameworks, (iii) secondary markets for distressed assets, and (iv) bank restructuring.[87]

On the regulatory side, a Single Rulebook was established in order to provide a single set of harmonised prudential rules to be respected throughout the EU. The single Rulebook consists of three main pillars: (i) the Capital Requirements Directive IV (CRD IV)[88] and Capital Requirements Regulation (CRR)[89] - known as the CRD IV Package - which implements the Basel III capital requirements; (ii) the Directive on Deposit Guarantee Schemes (DGSD), which regulates deposit insurance in case of a bank's inability to pay its debts; [90] and the Bank Recovery and Resolution Directive (BRRD), which establishes a framework for the recovery and resolution of credit institutions and investment firms in danger of failing.[91]

At level II, the Single Rulebook includes the Binding Technical Standards (BTS) issued by the EBA for the implementation of the main legislative acts, aiming at ensuring consistent harmonisation in each area of intervention, and the legislative measures adopted by national legislation implementing the directives and the provisions issued by each national banking authority. Furthermore, in relation to the SSM the Single Rulebook encompasses also the provisions issued by the ECB.[92]

### 1.2.3 Regulating Governance in the European Banking Union

As we have already seen in the previous sections, the conduit for creating an efficient and harmonized banking system is the implementation of a strong and complex reforming process which is still under development, and which involves the active intervention of the EU Commission, the EBA, the ECB and national supervisors and regulators. However, before analysing the interventions made in corporate governance framework, it should be recalled that in the process of bank

87 'Overview of Progress in Achieving Risk Reduction Measures (RRMs). A Follow-up Note to the February 2018 discussions on EMU deepening', available at https://www.consilium.europa.eu/media/35862/riskreduction.pdf, accessed 21 October 2018.
88 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.
89 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.
90 Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes.
91 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.
92 SSM Regulation, Article 4, par 3 and Article 9.

governance integration and rationalization, the EU legislator had to deal with many issues. The most relevant concerned the choice between a regulatory and a supervisory approach.

#### 1.2.3.1 Regulatory and Supervisory Approach

For many years, corporate governance of banks was subject to non-binding 'soft law' rules issued by the BCBS or agreed documents and contracts, such as corporate governance codes. However, the financial crisis marked a shift in this approach, and international financial authorities called for stricter regulation and supervision of the entire sector. Mülbert describes the relationship between corporate governance and banking regulation/supervision as a "functional relationship", as banking regulation and supervision fill the deficiencies in the monitoring activities carried out by depositors/debtholders in respect to the excessive risk taking by management (serving shareholders' interests).[93] In Europe, the most affected area in this regard has been compensation. At the beginning of the crisis, public opinion immediately accused bankers of being paid excessive bonuses, especially considered the actual performance of the credit institutions, and incentive compensation in general started to be conceived as one of the main determinants of the crisis. In dealing with the issue, the EU institutions adopted a regulatory approach – mainly based on the establishment of *ex-ante* fixed detailed rules – in opposition to the proposed supervisory approach - built on the establishment of principles to be flexibly implemented and *ex-post* overseen by supervisors. In particular, the EU introduced detailed rules, which largely reflect FSB principles and standards but, to a certain extent, also went beyond by setting out, for example, a cap on variable compensation, in order to limit the short-termism.[94] A regulatory approach was adopted also in relation to the maximum of number of directorships a director of the management body can hold.[95]

As a consequence, corporate governance in the banking sector, for the reasons earlier specified as well as for the strong preventive response EU regulators were

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93 Mülbert, n 21, 25,26.
94 *See* Guido Ferrarini, 'CRD IV and the Mandatory Structure of Bankers' Pay' in ECGI Law Working paper Series, ECGI - Law Working Paper No. 289, 2015, p.20. I further analyse the issue of compensation in Chapter IV, this thesis.
95 Directive 2013/36/EU, Article 91.

urgently called to enact, is no longer subject to non-binding soft rules.

The choice between a supervisory approach and regulatory approach in banking governance has been widely debated and the strict regulatory approach was subject to criticism. If we consider trust and, in particular, the restoration of public trust as one of the main objectives of the entire financial reforming process, the task facing corporate governance in banks is clearly complex and one that cannot be addressed only by means of a regulatory approach. The necessity to restore trust in the financial sector was shared by the EBA in the Guidelines on Internal Governance, where it stated that "trust in the reliability of the banking system is crucial for its proper functioning and a prerequisite if it is to contribute to the economy as a whole. Consequently, effective internal governance arrangements are fundamental if institutions, individually, and the banking system, are to operate well".[96]

However, as I better explain in Part II, trust is not only a matter of sound financial performance, but it largely relates to culture, in particular to the moral context in which financial operators behave. And whilst regulation may standardise internal control procedures, compensation schemes and risk management functions, establishing a sound culture seems to be out of reach, since dishonest bankers will always strive to find loopholes to circumvent legal obligations. As noticed by the G30, following the crisis, a strong focus was put on regulating risk-based capital, liquidity, resolution, and risk management, while no special attention was paid to maybe "softer", but fundamental issues, such as "enhancing supervisor-board relations to improve supervisor and board effectiveness, or on the culture of firms, which many observers consider to be contributors to the financial crisis."[97] For the complex and dynamic nature of some cultural aspects that corporate governance has to deal with, a supervisory approach seems to be more suitable (see the DNB case, Section 2.5.3). Let us just consider the difficulties regulators may encounter in providing strict rules concerning concepts such as 'independency', 'time commitment', and 'experience' with reference to key banks' board members. The hard task should be conferred not only to the banks board themselves, but also to the supervisory authorities, which should operate a double check on the banks' candidates or at least provide guidelines for the harmonization of the assessment

96 EBA, n 55.
97 G30, 'A New Paradigm: Financial Institution Boards and Supervisors', 2013, 11.

criteria. Supervisors, rather than regulators, are able to "…deal(ing) with complexity, innovation and continuous change".[98] Accordingly, the European Central Bank recently published a guide to fit and proper assessment –[99] which applies to the 19 euro area countries - in line with the 'Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body'.[100] The guidelines, as opposed to strict rules, are intended to be practical tools for bank boards that should be updated regularly in order to reflect new developments as well as experience gained through practice. Similar principles, but referring to the specific relationship between supervision and culture, have been acknowledged by the FSB,[101] the G30[102] and also by the De Nederlandsche Bank,[103] as I further analyse in Chapter V, Part II.

#### 1.2.3.2 The EU Regulatory Framework

In the EU, corporate governance of banking institutions is nowadays regulated al Level 1 by Directive EU/2013/36 (CRD IV), at Level 2 by the EBA Guidelines and, at the national level, by legislation implementing the EU directives and the regulatory measures issued by national authorities. The framework includes also the decisions issued by the ECB in its role of competent supervisory authority within the European Banking Union.

##### 1.2.3.2.1 CRD IV

By issuing the Capital Requirements Directive IV ('CRD IV') and the accompanying Capital Requirements Regulation ('CRR'), the EU implemented the

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98 Keynote, Mr Jaime Caruana (BIS General Manager), 'Regulatory stability and the role of supervision and governance', Tenth High-level Meeting on Global Banking Standards and Supervisory Priorities in the Americas, jointly organised by the Association of Supervisors of Banks of the Americas (ASBA), the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Institute (FSI), Montevideo, 28 October 2015.
99 ECB, 'Guide to fit and proper assessments' (May 2017).
100 ESMA and EBA, 'Guidelines on the assessment of the suitability of members of the management body and key function holders' (March 2018), ESMA71-99-598 EBA/GL/2017/12.
101 FSB, 'Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture', April 2014. Other related FSB reports include: 'Principles for an Effective Risk Appetite Framework', November 2013, and 'Principles for Sound Compensation Practices', April 2009.
102 G30, 'Banking conduct and culture: A call for sustained and comprehensive reform', July 2015.
103 Netherlands Authority for the Financial Markets (AFM) and De Nederlandsche Bank (DNB), 'Capacity for change in the financial sector', 2014.

Basel III capital requirements and leverage ratio requirements, but also introduced a mandatory set of standards for corporate governance, which applies to credit institutions and investment firms.[104] Actually, this is not the first attempt by the EU to harmonize banking governance, as Article 22(1) of the recast Banking Directive 2006/45/EC in 2006 required banks to provide robust governance arrangements, including a clear organizational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, as well as adequate internal control mechanisms, including sound administrative and accounting procedures.

CRD IV reflects the combination of the first governance arrangements established by the previous Directive and the additional standards set out, at the international level, by the BSBC[105] and the FSB,[106] and at the EU level, by the EBA in its Guidelines on Internal Governance,[107] and the EU Commission in the Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies of June 2010.[108] According to Mülbert and Wilhelm, the main regulatory purposes of the entire CRD IV framework are: (i) risk mitigation, (ii) stabilization of the EU financial Market, and (iii) the promotion of public interest, and the underlying conceptions are that "more regulation is better regulation" and that "character is the key to good corporate governance at board level (but money ruins everything, first and foremost character)".[109]

As a result, CRD IV now provides specific requirements in relation to: (a) board duties and composition; (b) risk management; and (c) remuneration policy.

a) Board functions and composition

With reference to the first subject, CRD IV establishes that the board is to

104 For an in depth analysis of CRD IV, *see* Peter O Mülbert & Alexander Wilhelm, 'CRD IV Framework for Banks' Corporate Governance', in Danny Busch & Guido Ferrarini (eds) *European Banking Union*, Oxford University Press, 2015, 155, 196-97.
105 We refer, in particular, to the BCBS Enhancements for the Basel II framework of July 2009, and to the BCBS, Principles for Enhancing Corporate Governance of October 2010 (an enhanced version of the 2006 paper on Enhancing Corporate Governance for Banking Organizations').
106 FSB, n 78.
107 EBA, n 55.
108 EU Commission, 'Green Paper: Corporate governance in financial institutions and remuneration policies, COM(2010) 284 Final.
109 *See* Peter Mülbert & Wilhelm, n 104, 169.

monitor bank's risk strategy, financial integrity, senior management and the proper of disclosure of information.[110]

CRD IV requires boards to comprise directors "of sufficiently good repute" with "sufficient knowledge, skills and experience to perform their duties", that should be carried out "with honesty, integrity and independence of mind to effectively assess and challenge the decisions of the senior management where necessary".[111] At the same time, the board should possess "adequate collective knowledge, skills and experience to be able to understand the institution's activities, including the main risks".[112] For this purpose, institutions must devote adequate human and financial resources to the induction and training of board members.[113]

Board members should also devote sufficient time to the task and, to this end, there are limitations on the number of directorships a member may hold at the same time.[114] In particular, unless representing a Member State, board members of a significant institution in terms of size, internal organization and nature, scope and complexity of its activities shall not hold more than (a) one executive directorship and two non-executive directorships or (b) four non-executive directorships at the same time, unless duly authorized by the competent authorities or assume one additional non-executive directorship.[115] Moreover, on the premise that boards should reflect "a broad set of qualities and competences", credit institutions are mandated to promote board diversity.[116] To this end, "individual board members' attitude should facilitate communication, collaboration and critical debate in the decision-making process".

Board diversity is in particular seen as a means of fighting the 'group-think' phenomenon, as well as when the board is dominated by a single, authoritative CEO or by a small group.[117] As a consequence, nomination committees – that should be established in large banks – should introduce targets for the "representation of the underrepresented gender" in the board.[118] Although CRD IV does not impose

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110 CRD IV, Article 88(1).
111 *Id.*, Article 91(1)(8).
112 *Id.*, Art 91(7).
113 *Id.*, Article 91(9).
114 *Id.*, Article 91(3)(4). In particular, Paragraph 4 mandates that not more than two non-executive roles at other organizations may be combined with one executive role, and not more than four non-executive roles in total may be held by any individual director
115 *Id.*, Art 91(4).
116 *Id.*, Article 91(10).
117 *See* Section 2.2.4.
118 CRD IV, Article 91(2)(a).

requirements in terms of proportions of independent directors in the board, it sets a clear separation between the role of Chair and Chief Executive Officer within the same institution, and specific independent requirements for members of the nomination, remuneration, and risk committees.[119]

As mandated by the Directive,[120] EBA issued specific guidelines on board composition and requirements (see Section 2.2.3.2).

b) Risk Management

In relation to risk management, CRD IV requires boards to approve and periodically review "the strategies and policies for taking up, managing, monitoring and mitigating the risks the institution is or might be exposed to".[121] In order to perform this function, the board must "devote sufficient time to consideration of risk issues", and that a risk committee be established by significant banks.[122] The requirement for the introduction of the risk committee undoubtedly represents the most significant change. The committee should be composed of non-executive directors with "appropriate knowledge, skills and expertise to fully understand and monitor the risk strategy and the risk appetite of the institutions", and it should perform several tasks: (i) assisting the board in identifying the institution's current and future risk appetite and strategy and in overseeing the implementation of the risk strategy by senior managers, and (ii) reviewing whether prices of liabilities and assets offered to clients do properly reflect risks in accordance with the business model and risk strategy.[123] The board or the risk committee is required also to ensure that incentive pay packages take into consideration risk, capital, liquidity and the likelihood and timing of earnings.

Credit institutions are also required to ensure they have established a "risk management function" independent from the operational functions and should ensure that all material risks are identified, measured and properly reported. The risk functions should also be involved "in elaborating the institution's risk strategy and in all material risk management decisions", as well as ensuring that "it can

119 *Id.*, Article 88(1) and 95.
120 *Id.*, Article 91(12).
121 *Id.*, Article 76(1).
122 *Id.*, Article 76(2)(3).
123 *Id.*, Article 76(3).

deliver a complete view of the whole range of risks of the institution".[124] The head of the risk management function, which depending "on the nature, scale and complexity of the activities of the institutions" should be a dedicated senior manager or another senior person, removable only with the prior approval of the board.[125]

c) Bankers' compensation

In line with FSB Principles, CRD IV establishes several criteria to be followed in the creation of the remuneration policy, all aimed at discouraging risk-taking that exceeds the level of institutions' "tolerated risk". Compensation policy should be: (i) "consistent and promote sound and effective risk management" and not "encourage risk-taking that exceeds the level of tolerated risk; (ii) in line with the business strategy, objectives, values and long-term interests of the institution; (iii) adopted and periodically reviewed by the board, at least annually".[126] For significant banks, a remuneration committee, composed of non-executive directors, should be established.[127] This has to prepare board decisions regarding remuneration by taking into consideration "the long-term interests of shareholders, investors and other stakeholders in the institution and the public interest".[128] With reference to variable compensation, as mentioned above, CRD IV goes beyond FSB Principles by imposing a cap on the amount of variable compensation that could be paid. This applies to senior management, but also refers to "risk takers, staff engaged in control functions and any employee receiving a total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile".[129] Variable compensation, established by taking into account both financial and non-financial assessment criteria, should not exceed the amount of fixed pay for any individual (one-to one ratio) or twice the size of the fixed pay if approved by the supermajority

124 *Id.*, Article 76(5).
125 *Id.*, Article 76(5).
126 *Id.*, Article 92(a-d).
127 *Id.*, Article 95.
128 *Id.*, Article 95(2).
129 *Id.*, Article 92(2). Pursuant to Article 94(2), the EU Commission adopted a delegated Regulation supplementing CRD IV as regards the identification of 'risk takers'. *See* Commission delegated Regulation (EU) 640/2014 of 4 March 2014 OJ L 167/30C, based on the respective EBA draft regulatory technical standard (EBA/RTS/2013/11) of 16 December 2013.

of shareholders.[130] Moreover, the Directive establishes that up to twenty-five per cent of the bonus may be paid in long-term instruments valued on a discounted basis, provided that these are deferred for at least five years.[131] With reference to variable remuneration, it is also required that at least fifty per cent of it should consist of shares or equivalent instruments that adequately reflect the credit quality of the institution as a going concern and are appropriate to be used for the purposes of variable remuneration. These instruments should be subject to "an appropriate retention policy designed to align incentives with the longer-term interests of the institution".[132]In addition, at least 40% of variable remuneration should be deferred over a period which is not less than three to five years.[133] Moreover, up to one hundred per cent of the variable compensation should be subject to *malus* or clawback arrangements, taking into account the situations of misconduct or failure in meeting fitness and propriety standards.[134]

From this brief overview, it emerges that the EU legislator provided detailed rules on executive compensation, with the aim to prevent the short-term approach that was widely recognized as one of the most patent corporate governance failures during the crisis. However, as I extensively discuss in depth in Chapter IV, Part II, legislators and policymakers, in regulating compensation, based remuneration principles and standards on traditional agency theory, and did not take into consideration recent behavioural studies on motivation and incentives.

d) Governance structures in CRD IV

By adhering to a functional position, CRD IV does not require the adoption of a specific governance structure, but instead keeps a substantive neutrality *vis-à-vis* the model of governance each bank chooses to adhere to.

By recognizing the presence of differences in governance structures across the Member States, the Directive itself clarifies that the definitions used in many provisions – such as "management body" and "management body in its supervisory function" – should "embrace all existing structures without advocating any

130 *Id.*, Article 94(1)(a)(g).
131 *Id.*, Article 94(g)(iii).
132 *Id.*, Article 94(l).
133 *Id.*, Article 94(m).
134 *Id.*, Article 94(n).

particular structure".[135] Accordingly, the term 'management body' is used to indicate the "institution's body or bodies [...] which are empowered to set the institution's strategy, objectives and overall direction, and which oversee and monitor management decision-making, and include the persons who effectively direct the business of the institution", while the expression "management body in its supervisory function" refers to "the management body acting in its role of overseeing and monitoring management decision-making".[136]

In line with CRD IV, the EBA, in its current Guidelines on Internal Governance[137] specifies that the terms "'management body in its management function' and 'management body in its supervisory function' are used throughout these guidelines without referring to any specific governance structure", and that "references to the management (executive) or supervisory (non-executive) function should be understood as applying to the bodies or members of the management body responsible for that function in accordance with national law."

The EU regulator therefore seems to have followed the same line adopted by the BCBS in its guidelines.[138] However, according to Mülbert,[139] although CRD IV formally embraced a neutral approach to governance structure, this is actually built on the one-tier board structure model, since many provisions would not easily apply to two-tier board systems.[140] This would, to a certain extent, cause an unjustified discrimination. First of all, the separation of CEO and board chair[141] clearly refers to the one-tier board system.[142] Second, the key definitions of "management body" and "management body in its supervisory functions" are evidently tailored to one-tier board structures and therefore create an unjustified ambiguity in the application of certain provisions for two-tier board systems. Due to these implementation

135 *Id.*, Recital 55.
136 *Id*, Article 3(7)(8).
137 EBA, Guidelines on internal governance under Directive 2013/36/EU (2017), (EBA/GL/2017/11), 8 (§22).
138 The BCBS clarified that the guidelines are "intended to guide the actions of board members, senior managers, control function heads and supervisors of a diverse range of banks in a number of countries with varying legal and regulatory systems, including both Committee member and non-member jurisdictions. The Committee recognises that there are significant differences in the legislative and regulatory frameworks across countries which may restrict the application of certain principles or provisions therein". See BCBS, n 72 §15
139 Mülbert & Wilhelm, n 104, 168.
140 Jaap Winter, 'The Financial Crisis: Does Good Corporate Governance Matter and How to Achieve it?', in Eddy Wymeersch, Klaus J. Hopt, and Guido Ferrarini (eds), *Financial Regulation and Supervision*, Oxford University Press, 2012, 12.21.
141 CRD IV, Article 88(1)(e).
142 Mülbert & Wilhelm, n 104, 173.

difficulties, the Directive itself clarifies that the "Member State(s) shall identify the bodies or members of the management body responsible in accordance with its (their) national law", and therefore confers excessive regulatory discretion to national legislators. However, the core of criticism refers to the concept of 'senior management', which is defined as "those natural persons who exercise executive functions within an institution and who are responsible, and accountable to the management body, for the day-to-day management of the institution."[143] In two-tier board systems – such as the typical German model – the definition actually refers to the members of the management board, who are "responsible and accountable for the day-to-day management of the undertaking".[144] Board requirements under Article 91 therefore apply to all members of senior management. On the contrary, the management body in the one-tier board system is not responsible for day-to-day management, and hence the same provisions apply only to members of senior management who are also members of the management body as executive directors, while the remaining senior managers are subject only to the requirements under Article 91(1). The result is that in two-tier board systems only members of the managing board may serve as Chief Risk Officer, while in one-tier systems also non-executive directors can be selected. Another consequence is that, since the remuneration committee is tasked with the direct supervision of the remuneration of "senior officers",[145] the rule would apply only to members of the managing board in two-tier board companies, but also to lower-ranked executives in one-tier board banks.

Notwithstanding the fact that most CRD IV rules are undoubtedly inspired by the most commonly adopted one-tier board system, and many ambiguities and inconsistencies make the implementation somehow troublesome, it should be argued that the alternative of providing different sets of rules would cause even more confusion and complexity. Moreover, we should also keep in mind that many scholars and practitioners in Germany advanced some legislative proposals that would allow companies to choose between alternative board models to better align with EU common practices.[146]

143 CRD IV, Article 3(9).
144 *Id.*, Recital 56.
145 *Id.*, Article 92(2)(f).
146 Carsten M Jungmann, 'The Effectiveness of Corporate Governance in One-Tier and Two-Tier Board Systems - Evidence from the UK and Germany', European Company and Financial Law Review (2006), 428-429.

1.2.3.2.2 EBA Guidelines

Since the publication of the Guidelines on Internal Governance in 2011 (revised in 2017),[147] the EBA has exercised its coordinating and supplementary functions to promote further harmonization of the banking system in relation to the specific internal governance arrangements, processes and mechanisms within the EU. The EBA should be also informed of the imposition of administrative penalties and other administrative measures, and it should maintain a central database of administrative penalties communicated to it, which is accessible to competent authorities.[148] However, the EBA does not share with the ESMA and the EIOPA direct supervisory powers on banks.

CRD IV entrusts the EBA with the development of technical standards, guidelines, and recommendations on specific aspects of banks' governance, to be incorporated in the Rulebook. In particular, the EBA is mandated for the issuance of guidelines concerning: (a) banks' governance arrangements, risk management and internal control mechanisms;[149] (b) sound remuneration policies, taking into account the 2009 Commission Recommendations and co-operating closely with ESMA;[150] and (c) various requirements applicable to the management body, including the notions of sufficient time commitment, adequate collective knowledge, skills and experience, honesty, integrity, independence of mind, and diversity.[151] Consistently, the EBA in 2013 issued Guidelines on sound remuneration policies,[152] followed in 2018 by the updated version of the Guidelines on Internal Governance[153], and by the Guidelines on the assessment of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU.[154]

It is useful to recall that the EBA guidelines are non-binding steps addressed to the competent national supervisory authorities, which they can decide to adhere

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147 EBA, n 55.
148 CRD IV, Arts 64-72.
149 *Id.*, Article 74(3).
150 *Id.*, Article 75(2).
151 *Id.*, Article 91(12).
152 EBA, Guidelines on sound remuneration policies under Articles 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013, EBA/GL/2015/22 (5 August 2016)
153 EBA, n 137.
154 EBA, n 137.

to by a compliance-or-explain mechanism.[155] With reference to the concept of "competent national supervisory authorities", it should be noted that, pursuant to Art 4(1)(e) of the SSM Regulation, the ECB has exclusive competence to ensure the compliance with the measures imposing "requirements on credit institutions to have in place robust governance arrangements, including the fit and proper requirements for the persons responsible for the management of credit institutions, risk management processes, internal control mechanisms, remuneration policies and practices and effective internal capital adequacy assessment processes, including Internal Ratings Based models". It means that the ECB – instead of national authorities – should declare its intention to comply with the Guidelines, as confirmed by the ECB in its opinion CON/2015/31. As a result, in 2016 the ECB notified the EBA its intention to comply with the Guidelines on sound remuneration policies,[156] and in 2018 with the latest version of the Guidelines on Internal Governance[157], as well as the Guidelines on the assessment of members of the management body and key function holders.[158] As for national competent authorities, they should not hinder the correct implementation of the directive or issue any binding regulatory provisions that may impede the soft nature of the provisions established in the directive and limit ECB supervisory powers.[159]

#### 1.2.3.2.3 ECB regulation

According to the SSM Regulation, in order to execute the tasks conferred at Article 4(1) and supervisory powers defined at Article 9 of the SSM Regulation, the ECB "shall apply all relevant Union law, and where this Union law is composed of Directives, the national legislation transposing those Directives". With reference to regulations granting options for Member States, "the ECB shall apply also the national legislation exercising those options".[160]

155 Regulation (EU) No 1093/2010, Article 16.
156 EBA, n 152.
157 EBA, n 137.
158 EBA, n 100.
159 In Italy, for instance, the Bank of Italy made provisions on corporate governance of banks binding.
160 SSM Regulation, Article 4(3).

Since the establishment of the SSM, the ECB has, by cooperating with the national supervisory authorities – in compliance with the two-level competency,[161] exercised its supervisory function on banks corporate governance through a constant dialogue with banks, by means of documentation assessments, meetings with key function holders, fit and proper assessments and conferences dedicated to governance. For instance, at the Second Supervisory Conference held on 22 March 2018, [162] the ECB highlighted four main governance issues to be addressed in banks: fit and proper assessments, board independence, risk appetite frameworks and risk reporting and data aggregation. In the first area, the ECB, which is responsible for the assessment of the appointment of all members of the boards of significant banks under its direct oversight, in May 2017 published the 'Guide to fit and proper assessments',[163] whose contents are aligned in May 2018 with the joint ESMA and EBA Guidelines on the assessment of members of the management body and key function holders but also with the EBA Guidelines on Internal Governance. Both the EBA Guidelines, far from being replaced by the ECB Guidelines, should serve to "provide(s) explanations on the processes conducted by the ECB and specifies the ECB's main expectations when conducting sound and consistent suitability assessments".[164]

161 As mentioned before, the ECB directly supervises the 'more significant bank', defined by the SSM Regulation as those meeting at least one of the following criteria: (a) a total balance sheet assets exceeding € 30 billion, (b) being significant for the specific country or the EU economy as a whole, (c) having a total value of its assets exceeding €5 billion and the ratio of its cross-border assets/liabilities in more than one other participating Member State to its total assets/liabilities being above 20%; (d) having requested or received funding from the European Stability Mechanism or the European Financial Stability Facility. See respectively Articles 6(4). The less significant banks are supervised directly by the competent national authorities, even though the supervision performed by the national authorities is framed by issuing regulations, guidelines and general instructions.

162 Speech, Danièle Nouy, 'Governance expectations for banks in a changing financial environment', 22 March 2018, available at https://www.bankingsupervision.europa.eu/press/speeches/date/2018/html/ssm.sp180322_1.en.html, accessed 30 Oct 2018.

163 ECB, n 99.

164 *Id.*, 6.

# Chapter III

## Restoring Investors' Trust within EU Regulatory Framework*

1.3.1 Introduction. – 1.3.2 Investor protection: the EU path towards harmonisation. – 1.3.2.1 Disclosure of product information. – 1.3.2.2 Conduct of business (COB) rules. – 1.3.2.3 Product governance and intervention. – 1.3.2.4 Financial Education. – 1.3.3 Conclusion.

### 1.3.1 Introduction

In addition to the specific initiatives regulating the banking sector, in September 2015 the EU Commission published its Action Plan on building a Capital Markets Union (CMU) to further integrate the financial markets and harmonize the financial system.[165] The Action Plan, by setting out a list of key measures[166] to foster the creation of a single market by 2019, requires the enactment of legislative and non-legislative initiatives indirectly involving the banking sector too. In June 2017, the Commission published its Communication on the Mid-Term Review identifying the nine key priorities for the second half of the Juncker Commission's term.[167]

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*This Chapter is drawn from a previous work: Michele Siri & Shanshan Zhu, 'EU Investor', in A. Bartolini et al. (eds), *Dictionary of Statuses within EU Law*, Springer, 2019, 209-217.

[165] European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions Action Plan on Building a Capital Markets Union, COM(2015) 468 final. The Communication was preceeded by a Green Paper on Capital Markets Union, COM(2015) 63 final.

[166] These are: (a) financing for innovation, start-ups and non-listed companies, (b) facilitating the access to the public markets, (c) promoting long term and sustainable investment, (d) fostering retail investment, (e) strengthening banking capacity to lend, (f) strengthening the capacity of EU capital markets, and (g) facilitating cross-border investment.

[167] The nine new priority actions are: (i) reinforcing effectiveness and consistent supervision across the EU; (ii) delivering a more proportionate regulatory environment for SME listing on public markets; (iii) reviewing the prudential treatment of investment firms; (iv) assessing the case for an EU licensing and passporting framework for FinTech activities; (v) presenting measures to support secondary markets for non-performing loans (NPLs) and explore legislative initiatives to strengthen the ability of secured creditors to recover value from secured loans to corporates and entrepreneurs; (vi) ensure follow-up to the recommendations of the High Level Expert Group on Sustainable Finance; (vii) facilitating the cross-border distribution and supervision of UCITS and alternative investment funds (AIFs); (viii) providing guidance on existing EU rules for the treatment of cross-border EU investments and an adequate framework for the amicable resolution of investment disputes; and (ix) proposing a comprehensive EU strategy to explore measures to support local and regional capital market development. See European Commission, Communication from the Commission to the European Parliament, the council, the European Economic and Social Committee and the Committee Of The Regions on the Mid-Term Review of the Capital Markets Union Action Plan, COM(2017) 292 final.

Following the financial turmoil in 2007, and considered the increasing complexity of financial markets, the EU strengthened its regulatory efforts to set a proper level of protection and transparency in investment services.[168] In particular, by introducing the Directive on Markets in Financial Instruments (MiFID)[169], the related Markets in Financial Instruments Regulation (MiFIR),[170] the Insurance Distribution Directive[171] and the Regulation on key information documents for packaged retail and insurance-based investment products (PRIIPs)[172], the EU recently provided the main – sometimes overlapping – criteria to be followed by financial intermediaries in the performance of their activities.

In the regulatory development of the Capital Markets Union, we registered a shift towards a sort of 'paternalistic' approach, intended to prevent further episodes of financial misbehaviour. In particular, the objective of the recent cross-sectorial reforms can be identified in the attempt to establish an investor protection regime harmonised in all banking, investment and insurance sectors that encompasses the largest number of financial services and instruments.

### 1.3.2 Investor protection: the EU path towards harmonisation

We can define 'investor protection' as the set of rules and principles expected to preserve the interests and the rights of a person in its role as the investor, or the 'defensive protection of the vulnerable investor against unscrupulous market participants'.[173] The aim of the regulation concerning investor protection is to allow the investors to make informed financial decisions that are better aligned with their interests and profile.

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[168] *See* Directive 2014/65/EU, Recital 3 and 4.

[169] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (MiFID I), recently revised with the Directive 2014/65/EU, Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (MiFID II).

[170] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

[171] Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution (recast).

[172] Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs Regulation).

[173] Robert C Clark, 'The soundness of financial intermediaries?, Yale Law Journal (1976), 86, 1, 1-102.

In particular, based on previous contributions on the subject,[174] we can distinguish among four main dimensions of EU investor protection regulation: (1) disclosure of product information, (2) conduct of business (COB) rules, (3) product governance and intervention and (4) financial education.[175]

#### 1.3.2.1 Disclosure of product information

The first focus area addressed by the EU financial authorities is represented by the obligation to disclose information on the provided financial product. The disclosure of information – aiming not only at protecting unsophisticated investors' trading in the securities market but also at ensuring the efficiency of the financial markets and reducing agency costs[176] – has become an essential requirement since the introduction of the obligation to produce a prospectus.[177] This obligation, which was first harmonised at the EU level in 1985 and initially targeted only undertakings for collective investment in transferable securities (UCITS funds),[178] evolved in order to introduce the so-called 'Key Investor Information Document' (KIID), a two-page document containing the essential features of the fund,[179] and finally extend to a larger range of financial products with the 'Key Investor Document' (KID).

The KID, modelled after the UCITS KIID and introduced with the PRIIPs Regulation,[180] targets 'PRIIP manufacturers' (i.e., fund managers, insurance undertakings, credit institutions and investment firms).[181] Moreover, it applies to 'all products, regardless of their form or construction, that are manufactured by the

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[174] *See* Veerle Colaert, 'Building blocks of investor protection: All-embracing regulation tightens its grip', Journal of European Consumer and Market Law (2017), 6, 229-244; Niamh Moloney, *How to protect investors: Lessons from the EC and the UK*, Cambridge University Press, 2010; Niamh Moloney, 'Regulating the retail markets', in N Moloney, E Ferran and J Payne (Eds), *The Oxford handbook of financial regulation* , Oxford University Press, 2015, 736-765.
[175] In this Chapter, I decided not to treat enforcement mechanisms in order to focus on *ex-ante* mechanisms.
[176] Luca Enriques & Sergio Gilotta, 'Disclosure and financial market regulation', in N Moloney, E. Ferran and J Payne (Eds), *The Oxford handbook of financial regulation*, Oxford University Press, 2015, 511-536.
[177] Directive 1985/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS Directive), Arts 27 and 28.
[178] *Id.*, Article 1.
[179] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS IV), Article 78.
[180] PRIIPs Regulation.
[181] *Id.*, Recital 12.

financial services industry to provide investment opportunities to retail investors'; therefore, it covers financial instruments pertaining to the banking, investment and insurance sector.[182] The KID should be a three-page, stand-alone document that is clearly separated from other marketing material, easily readable and contain 'accurate, fair, clear and not misleading' information.[183]

The European Commission recently proposed to introduce a similar requirement in the context of a Regulation on a pan-European Personal Pension Product (PEPP).[184] This regulatory effort can be explained with the EU's intention to deal with the problems of information overload,[185] investors limited rationality, deviant behaviour[186] and non-uniformity among different types of financial products.

1.3.2.2 Conduct of business (COB) rules

COB regulation, originally deriving from the fiduciary doctrine,[187] aims at protecting investors from harm caused by the conduct of financial intermediaries during the operations performed for the investors or on their behalf. The first attempt to provide a minimum harmonised set of standards among the Member States was realised in 1993, with the issuance of the Investment Services Directive (ISD),[188] which is modelled after the International Conduct of Business Principles, published by the International Organisation of Securities Commissions (IOSCO) in 1990.[189] However, this original and rather simple regulatory scheme did not provide sufficient investor protection, nor did it establish a completely harmonised system.[190]

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[182] *Id.*, Recital 6.
[183] PRIIPs Regulation, Arts 6(1), (2) and (4).
[184] Proposal for a Regulation of the European Parliament and of the Council on a pan-European Personal Pension Product (PEPP) (COM (2017) 343 final), Article 23.
[185] Troy A Paredes, 'Blinded by the Light: Information Overload and Its Consequences for Securities Regulation', Washington University Law Quarterly (2003), 81, 417-485.
[186] For a review of the literature on behavioural finance, *see* Nicholas Barberis & Richard Thaler, 'A survey of behavioural finance', in G Constantinides, M Harris, & R M Stulz (Eds), *Handbook of the economics of finance: Financial markets and asset pricing*, North Holland , 2003, 1051-1121.
[187] Andrew F Tuch, 'Conduct of business regulation', in N. Moloney, E. Ferran & J. Payne (Eds), *The Oxford handbook on financial regulation*, Oxford University Press, 2015, 537-567.
[188] Directive 93/22/EEC Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (ISD). This followed the European Recommendation to introduce some basic COB rules (Recommendation 77/534/EEC, OJ L 212/37).
[189] International Organisation of Securities Commissions (IOSCO), 'International Conduct of Business Principles' (1990).
[190] Ryan J Davies, Alfonso Dufour, and Brian Scott-Quinn, 'The MiFID: Competition in a new European equity market regulatory structure', in G. Ferrarini & E. Wymeersch (eds), *Investor*

A more extensive set of rules was introduced in 2004 with the 'Markets in Financial Instruments Directive' (MiFID I)[191] and its Implementing Directive (2006/39/EC), which replaced the ISD standards and revised many times during the years that followed.[192] Under the Directive 2014/65/EU (MiFID II) and its implementing Standards, the current COB rules provides a stricter and more detailed set of rules governing a large range of financial services. MiFID II, in particular, applies to all investment firms, credit institutions and UCITS management firms when providing investment services or ancillary services; thus, it generally requires financial intermediaries to 'act honestly, fairly and professionally in accordance with the best interests of (their) clients'.[193]

Within this complex reforming process, we can identify some fundamental tendency lines that were followed by the European authorities. These concern: (1) widening the scope of the COB rules, (2) distinguishing between independent and non-independent financial advice, (3) specifying the duty to act in the client's best interest and (4) strengthening the information obligation.

The first relevant change concerns widening the scope and target of the COB rules. Even though the Investment Services Directive covered investment services in general, some common practices (such as financial advice and commodity derivatives) were not included since they were not identified as financial services. MiFID I upgraded investment advice from an ancillary service to a core investment service, and certain commodity derivatives were included among the financial instruments.[194] Moreover, MiFID II now draws a distinction between independent and non-independent financial advice. In detail, investment firms are required to disclose whether they provide investment advice on an independent basis,[195] and in such a case, they should assess a sufficiently diverse range of financial products – in

*protection in Europe: Corporate law making, the MiFID and beyond*, Oxford University Press, 2006, 163-198).

[191] MiFID I.

[192] *See* Directive 2006/31/EC of the European Parliament and of the Council of 5 April 2006 amending directive 2004/39/EC on markets in financial instruments, as regards certain deadlines; Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007 amending Council Directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector; Directive 2008/10/EC of the European Parliament and of the Council of 11 March 2008 amending Directive 2004/39/EC on markets in financial instruments, as regards the implementing powers conferred on the Commission.

[193] MiFID II, Article 24(1) .

[194] *Id.*, Section 1, Annex I (5), Recital 4 and Par. I, Annex II.

[195] *Id.*, Recital 72 and Article 24(4).

terms of issuers and product providers – before making their recommendation.[196]

In order to avoid conflicts of interest, MiFID II establishes specific restrictions to the possibility for investment firms to accept or retain fees, commissions or any monetary and non-monetary benefits from third parties ('inducements'). With reference to independent advice, these should be immediately returned to the clients, except for certain minor non-monetary benefits that are capable of enhancing the quality of service provided – investment research included[197] – which should, however, be clearly disclosed.[198] As for non-independent advice, inducements are allowed if they are (a) designed to enhance the quality of client services, (b) consistent with the firm's duty to act in a client's best interest and (c) clearly disclosed to the affected client. Thus, the European legislator chose not to follow the United Kingdom (UK) experience of the Retail Distribution Review, which put an inducement ban on both 'independent' and 'restricted' advice.[199] In the Commission proposal for a PEPP regulation, the EU authorities introduce a similar CBR for PEPP distributors.[200]

The third area of EU intervention is regarded as the general principle to which investment firms should act in the clients' best interests when dealing.[201] MiFID II strengthened this general standard that represents a key interpretation of what is further specified in other provisions,[202] such as those concerning conflict of interest,[203] inducements,[204] staff remuneration practices,[205] best execution[206] and the

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[196] *Id.*, Recital 73 and Article 24(7)(a).

[197] Silverentand, Larissa, Sprecher Jasha, and Lisette Simons, 'Inducements', in D. Busch & G. Ferrarini (eds), *Regulation of the EU financial markets: MiFID II and MiFIR*, Oxford University Press, 2017, 205-225.

[198] MiFID II, Recital 74 and Article 24(7)(b).

[199] Paolo Giudici, 'Independent financial advice', D. Busch & G. Ferrarini (eds), *Regulation of the EU financial markets: MiFID II and MiFIR*, Oxford University Press, 2017, 147-163.

[200] Proposal for a Regulation of the European Parliament and of the Council on a PEPP, Article 23.

[201] MiFID II, Article 24(1).

[202] Luca Enriques & Matteo Gargantini, 'The overarching duty to act in the best interest of the client in MiFID II in D. Busch & G. Ferrarini (eds), *Regulation of the EU financial markets: MiFID II and MiFIR*, Oxford University Press, 2017, 85-122.

[203] MiFID II, article 23 and Recital 56. MiFID II does not define or prohibit conflicts of interest. Instead, conflicts of interest shall be avoided, taken into account and managed. *See* Martin Brenncke, 'Commentary on MiFID II conduct of business rules', in M. Lehmann & C. Kumpan (Eds), *Financial Services Law,*1 edition, Hart Publishing, 2017, Arts 21-30 MiFID II; Jonathan Herbst, *A practitioner's guide to MiFID II*, 2nd edition, Sweet & Maxwell/Thomas Reuters, 2016, 94. For further discussion, see also Stefan Grundmann & Philip Hacker, 'Conflict of interest', in D. Busch & G. Ferrarini (eds), *Regulation of the EU financial markets*, Oxford University Press, 2017, 165-204.

[204] MiFID II, Arts. 24(8) and (9).

[205] MiFID II, Article 24(10). Staff should not be remunerated in such a way that they recommend a particular financial instrument without taking into account the retail client's best interest.

suitability or appropriateness assessment.[207]

The fourth fundamental subject of reform is represented by the strengthened information obligations. While the ISD provided only the obligation for the investment firm to adequately disclose the 'relevant material information on its dealings with its client',[208] MiFID I – as well as MiFID II – poses a new set of information duties on financial intermediaries. All information addressed from the investment firm to clients or potential clients should be 'fair, clear and not misleading'.[209] Appropriate information should include the investment firm and its services, the financial instruments and proposed investment strategies, execution venues, appropriate guidance on and warnings of the risks associated and the costs and associated charges. In reference to financial advice, investment firms should also inform the client on whether their advice is based on a broad or on a more restricted analysis of different types of financial instruments, especially if the firm will periodically assess the suitability of the recommended financial instruments.[210] Specific information duties have been introduced in relation to investment services offered together with other services or as a part of a package.[211] Moreover, MiFID II now requires the producers to provide information about the product; therefore, an amplified cooperation with product manufacturers is necessary.[212]

#### 1.3.2.3 Product governance and intervention

In opposition to the approach previously adopted by the EU policymaker,[213] the last financial crisis and the recent scandals showed the need to protect clients from harmful financial products by preventing them to even access to the market.

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[206] MiFID II, Article 27. Investment firms shall take all reasonable steps to obtain the best possible result in the execution of clients' orders, with a different regime depending on the nature of the investor (i.e., either professional or retail).
[207] MiFID II, Article 25(2) and (3). In particular, the suitability assessment requires that portfolio managers and financial advisors shall gather information about their client's knowledge, experience, investment objective and risk tolerance – in relation to investment products and services – in order to recommend to the client the investment services and financial instruments that are best aligned with the client's profile. The appropriateness requirement provides that the investment firm gathers information on the client in order to assess if the product or services offered or demanded were appropriate.
[208] ISD, Article 11.
[209] MiFID II, Article 24(3).
[210] *Id.*, Article 24(4)(a).
[211] *Id.*, Article 24(11).
[212] Colaert, n 174, 229-244.
[213] In the past, in order to support market innovation, the EU legislator avoided to impose any quality requirement for financial products. *See* Colaert, n 174, 229-244.

The first attempts to govern the quality of financial instruments were realised by the UCITS Directive,[214] which regulated the conditions under which an investment fund could be allowed to use the label 'UCITS'. Other attempts were made by the Alternative Investment Fund Managers Directive (AIFMD),[215] which intervened on (non-UCITS) funds' managers by requiring them to fulfil certain quality requirements.

In the meantime, some Member States, such as the UK, started issuing some principles regulating product governance.[216] Finally, encouraged by the ESMA opinion,[217] MiFID II and IDD established specific product governance and intervention rules.

Investment and insurance intermediaries shall now undergo a product approval process before marketing and distributing a financial instrument. In particular, they shall

> 'specify an identified target market for each product, ensure that all relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market, and take reasonable steps to ensure that the insurance product is distributed to the identified target market'.[218]

Moreover, a review process shall be regularly performed in order to assess whether the financial instrument remains consistent with the needs of the identified target market and whether the intended distribution strategy remains appropriate. In such a way, the quality assessment of financial product covers its entire life cycle, starting at the design phase and ending with the review phase. MiFID II clearly assigns to the management body the duty to define, oversee and implement the policy in relation to the products offered or provided.[219]

In addition, MiFID II and PRIIPs Regulation, in order to address an investor protection concern or preserve the integrity of the financial system, attributed some

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[214] Originally directive 1985/611/ECC.
[215] Directive 2011/61/EU on Alternative Investment Fund Managers Directive (AIFMD). The Directive was introduced in order to protect investors in the non-UCITS sector.
[216] *See* Colaert, n 174, 229-244.
[217] ESMA, 'Opinion. Structured Retail Products – Good practices for product governance arrangements', ESMA/2014/332, March 2016.
[218] MiFID II, Article 16(3), IDD, Article 25. See also ESMA, 'Final Report: Guidelines on MiFID II product governance requirements' (2017), ESMA35-43-620.
[219] MiFID II, Article 9(3)(b).

product intervention powers to European Supervisory Authorities,[220] according to which these authorities may temporarily prohibit the marketing, distribution and sale of certain products to retail investors or a type of financial activity or practice.[221] These stricter *ex-ante* and *ex-post* product governance mechanisms will probably entail some extra costs for firms, but they are deemed acceptable, especially considered the damages that can derive from an inadequate investor protection framework.[222]

#### 1.3.2.4 Financial education

A final segment of intervention for the reinforcement of investor protection concerns the improvement of financial literacy in the context of Member States. In the view of EU authorities, the financial crisis confirmed that 'financial education is not a substitute for consumer protection, but a key element of the consumer protection framework'; however, since it fails to represent 'the underlying cause for the crisis . . . it may have contributed to worsening the impact of the financial crisis in Europe in the autumn of 2008".[223] As one of the 'post-crisis top priorities', financial education has been at the centre of many institutional documents and initiatives. At the international level, it has been mainly promoted by the Organisation for Economic Co-operation and Development (OECD) and its International Network on Financial Education (INFE), whereas it took form at the domestic level, especially in terms of cooperation between supervisors and various entities involved in consumer protection and of cooperation between supervisors and schools and the academic sector.[224]

In 2017, the European Banking Authority (EBA) established a repository in which is gathers financial education initiatives promoted by national authorities and those that fall within the scope of its competence.[225] To date, the repository consists of 84 initiatives, most of which are established in Ireland, Portugal and Sweden and

[220] To ESMA for financial instruments, to EBA with reference to structured deposits, to the EIOPA in relation to insurance-based investment products.
[221] MiFIR, Arts 40-41, and PRIIPs Regulation, Article 16.
[222] Danny Busch, 'Product governance and product intervention under MiFID II/MiFIR', in D Busch & G Ferrarini (eds), *Regulation of the EU financial markets: MiFID II and MiFIR*, Oxford University Press, 2017, 123-146.
[223] Expert Group on Financial Education, 'The Financial Crisis and Financial Education' (2009).
[224] EIOPA, 'Report on Financial Literacy and Education Initiatives by Competent Authorities' (2011).
[225] EBA, 'EBA Financial Education Report 2017/2018' (2018).

consist of online resources. However, in line with the strive to reach harmonisation at a cross-sectoral level among financial services, the objective for the future is to publish reports via the Joint Committee of the European Supervisory Authorities (i.e., ESMA, EBA and EIOPA).[226]

### 1.3.3 Conclusion

Starting from the publication of the de Larosière Group report,[227] the European initiated an increasingly intense process of reforming investor protection instruments in the context of the European Capital Markets Law, marking a shift from a minimum to a maximum harmonisation approach.[228] Nowadays, all financial intermediaries on a cross-sectorial basis – pertaining to the securities, banking and insurance sector – shall provide all the information necessary for both retail and professional investors to make the investment choices that are aligned with their best interests. Even though the new rules concerning the obligation to provide a KID or KIID, the distinction between financial and non-financial advice, the related limitation to inducements and the new process of product governance and intervention have been the most discussed, however, their effectiveness has to be evaluated in the next years.

However, notwithstanding the high number of legislative reforms enacted in the financial sector and briefly described in this Part, an in-depth analysis of the main cultural root causes of misconduct should still be conducted. Hence, Part II of this thesis will focus on the evaluation of corporate governance arrangements under the lights of behavioural sciences, in order to show how an interdisciplinary approach is necessary to make investor protection initiatives more effective and prevent future misbehaviour.

[226] EIOPA, n 224.
[227] *See* n 56.
[228] Tomas M J Möllers, 'European legislative practice 2.0: Dynamic harmonisation of capital markets law – MiFID II and PRIIP', *Banking & Finance Law Review* (2016), 31,1, 141-176.

# PART II[229]

# TOWARDS A SOUND CULTURE AND CONDUCT IN BANKS

[229] This part is partially drawn from my previous work Guido Ferrarini & Shanshan Zhu, 'Culture of Financial Institutions', in D Busch, G Ferrarini and G van Solinge (eds), *Governance of Financial Institutions*, Oxford University Press, 2019, *Forthcoming*.

# Chapter I

## Culture in Financial Institutions

2.1.1 Introduction. – 2.1.2 A new approach to financial reform. – 2.1.3 Culture and morals: an ethical perspective. – 2.1.4 Defining Culture. – 2.1.5 Diagnosing culture.

### 2.1.1 Introduction

Only in the last few years financial regulators, supervisors, and scholars have focused on the role of ethics and culture in the financial services industry as determinants of either good or bad behaviour. The current attention to ethics and culture can be easily understood considering the disdain that followed the shocking misconducts carried out by financial firms both in the United States[230] and in Europe.[231] Inadequate rules, bad corporate governance and lack of public enforcement cannot fully explain malpractice. Neither can they clarify why financial firms apparently operating in similar contexts, under similar rules and incentive structures, did not reach the same outcomes in terms of viability and performance.

In order to get to the root of the problem, it is necessary to first assert something obvious: banks are run by human beings. As a consequence, to understand how to fix banks, it is necessary to first understand how to fix people's behaviour. In terms of policy, scholars and authorities should pay renewed attention to corporate governance structures in the financial sector in addition to regulation. However, following the traditional lawyerly approach to corporate governance based on the standards and procedures described in the previous chapters may not

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[230] The Wells Fargo case will be considered below. *See* Susan M Ochs, 'The Leadership Blind Spots at Wells Fargo', Harvard Business Review, 6 October 2016, available at https://hbr.org/2016/10/the-leadership-blind-spots-at-wells-fargo, accessed 14 January 2018.

[231] For instance, the J. P. Morgan's London Whale case, the Libor and Forex manipulation scandals, and the infamous episodes involving BSI, Swiss Bank, BNP, Deutsche Bank and Danske Bank. See Thomas C Baxter, 'Reflections on the New Compliance Landscape, Remarks at The New Compliance Landscape: Increasing Roles Increasing Risks Conference', New York City, 2014. See Paolo Giudici, The Venetian Banks' Collapse, in D. Busch, G. Ferrarini and G. van Solinge (eds), *Governance of Financial Institutions*, Oxford University Press, 2019, *Forthcoming*; Maribel Sáez and María Gutiérrez, 'The Spanish Banking Crisis', in D. Busch, G. Ferrarini and G. van Solinge (eds), *Governance of Financial Institutions*, Oxford University Press, 2019, *Forthcoming*; José Engrácia Antunes, 'Anatomy of a Banking Scandal in Portugal', in D. Busch, G. Ferrarini and G. van Solinge (eds), *Governance of Financial Institutions*, Oxford University Press, 2019, *Forthcoming*; and Bas de Jong, 'Governance Problems in Dutch Financial Institutions from 2007 to 2017', in D. Busch, G. Ferrarini and G. van Solinge (eds), *Governance of Financial Institutions*, Oxford University Press, 2019, *Forthcoming* for an in-depth analysis of banking scandals in Italy, Spain, Portugal and the Netherlands respectively.

be sufficient, while the risk of adding costs and bureaucracy within financial institutions is high. Governance models should be rather analysed with a focus on the organizational and cultural aspects of institutions. Scholars in this area should therefore undertake in-depth studies on the determinants of human behaviour, the relevant processes, and the motivations leading people to act the way they do. A number of research questions should be asked in particular, such as the following:

(i) What drives white-collar criminals, who often are wealthy and highly educated professionals, well paid and highly esteemed in influential parts of society, to risk their success, reputation, and prospected incomes when committing fraud?

(ii) How did it happen that some financial firms awarded for their good corporate governance system were heavily hit by scandals?

(iii) What makes codes of ethics just valueless and ineffective pieces of paper?

These questions should be answered from an interdisciplinary perspective, involving not only law and economics, but also other social sciences, such as anthropology, sociology, and psychology, which offer fundamental insights on the determinants of financial misconduct. This will better explain why financial scandals not only concern 'bad apples', but also good people acting in highly unethical contexts ('bad barrels'), where they confront moral dilemmas ('bad cases').[232]

The idea that a cultural shift is needed in the financial industry is already widespread amongst national and international regulators, as will be better explained in the next section. Contrary to Milton Friedman's suggestion that the only responsibility of business is to maximize shareholder value, many are convinced today that firms should also pursue ethical values and that this goal is not opposite to profit.[233] As highlighted for the first time by Bowen in 1953,[234] in order to create long-term value, financial institutions should enhance the ability of people working for them at each level to make decisions in a responsible manner.[235] The

[232] Jennifer J Kish-Gephart, David A Harrison, and Linda Klebe Treviño, 'Bad Apples, Bad Cases, and Bad Barrels: Meta-Analytic Evidence About Sources of Unethical Decisions at Work' Journal of Applied Psychology (2010), 95, 1, 1–31.

[233] *See*, e.g., Lynn A Stout, 'Shareholder Value Myth', Cornell Law Faculty Publications, Paper 771/2013.

[234] *See* Howard R Bowen, *Social Responsibilities of the Businessman*, Harper, 1953, 8–13.

[235] Incidentally, non-financial value drivers (such as company's reputation, customer satisfaction and loyalty, staff competence, employee satisfaction and turnover, and innovative potential, proved to be

UK Financial Reporting Council (FRC), in its 2016 'Report on Corporate Culture and the Role of Boards', similarly stated: "a healthy culture both protects and generates value. It is therefore important to have a continuous focus on culture, rather than wait for a crisis". According to a recent paper by Shefrin, psychological phenomena – as illustrated by analysing five specific cases (UBS, Standard & Poor's, American International Group, the investment committee for the town of Narvik, Norway, and the U.S. SEC) – caused most of the worst consequences of the 2008 crisis, as "point–induced risk seeking, excessive optimism, overconfidence, and categorization were at work".[236]

According to the Group of Thirty (G30), the most recent business scandals have been caused by a combination of sociological and governance reasons, such as lack of diversity, presence of dominant companies, high dependence on specialized skills, misaligned incentives, and ineffective leadership and managerial skills.[237]

To be sure, there is a significant literature on the determinants of organizations' culture, its connection with firm performance,[238] and the ways to measure and change it for the better,[239] but few have studied organizational culture with specific reference to financial institutions.[240] This Part suggests a new approach to the study of culture in financial institutions, which could assist the regulatory reform and the revamping of the financial sector and prevent malpractice

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relevant in determining a bank's value in a study on Latvian banks. *See* Jelena Titko and Inga Shina, 'Non-financial Value Drivers: Case of Latvian Banks', Procedia Engineering (2017) 178, 192–9.

[236] Shefrin Hersh, How Psychological Pitfalls Generated the Global Financial Crisis (December 15, 2009). Laurence B Siegel (ed.), Voices of Wisdom: Understanding the Global Financial Crisis, Charlottesville, VA: Research Foundation of CFA Institute.

[237] G30, 'Banking Conduct and Culture: A Permanent Mindset Change', 2018, 11.

[238] *See*, e.g., Benjamin E Hermalin, 'Economics and Corporate Culture', in Cary L Cooper, Sue Cartwright, and P Christopher Earley (eds) *The International Handbook of Organizational Culture and Climate*, Wiley, 2001, 217–61; Luigi Guiso, Paola Sapienza, and Luigi Zingales, 'Does Culture Affect Economic Outcomes?' Journal of Economic Perspectives (2006), 20, 23–48; John P Kotter and James L Heskett, *Corporate Culture and Performance*, Free Press, 1992; Jesper B Sørensen, 'The Strength of Corporate Culture and the Reliability of Firm Performance' Administrative Science Quarterly (2002), 47, 1, 70–91; Daniel R Denison, *Corporate Culture and Organizational Effectiveness*, Wiley, 1990; George G Gordon and Nancy Di Tomaso, 'Predicting Corporate Performance from Organizational Culture', Journal of Management Studies (1992), 29, 83–798.

[239] *See*, e.g., Sonia A Sackmann,'Uncovering Culture in Organizations', The Journal of Applied Behavioural Science (1991), 27, 3, 295–317; and John R Graham et al, 'Corporate Culture: Evidence from the Field', Duke I&E Research Paper No 33/2016, available at http://ssrn.com/abstract=2805602, accessed 30 October 2018.

[240] *See* Andrew W Lo, 'The Gordon Gekko Effect: The Role of Culture in the Financial Industry' FDRNY Economic Policy Review (2016), 18; Anjan Thakor, 'Corporate Culture in Banking', Economic Policy Review, Issue August 5–16 2016, available at http://ssrn.com/abstract=2828071, accessed 30 October 2018; Gordon Gwendolyn and David T Zaring, 'Ethical Bankers' The Journal of Corporation Law (2017), 42, 3, available at https://ssrn.com/abstract=2932317, accessed 30 October 2018.

with the help of concepts and methodologies drawn from social sciences other than law and economics. Regulation, to quote Winter, "often is not the best way to deal with the persistent governance problems, either because it cannot deal with the intricacies of corporate and human reality… or because it will be ineffective as long as underlying generally held beliefs, world views, assumptions and paradigms remain unaffected (…) It takes courage not to regulate and seek alternative avenues to address such problems."[241]

The rest of the Part proceeds as follows. The current Chapter briefly offers an overview of the scholarly definitions of culture in social sciences and of the models suggested to diagnose it. Chapter II discusses the role of leadership in shaping culture. Chapter III analyses internal controls, with specific reference to risk culture and the psychology of compliance. Chapter IV recommends a new approach to incentives and remuneration schemes, which is grounded on a critical view of the same as currently used in financial and non-financial firms. Chapter V discusses the role of institutional investors and supervisory authorities in shaping culture.[242] Finally, Chapter VI focuses on the current development of sustainable finance initiatives, which may contribute to the shift towards a long-term oriented culture in the financial sector.

### 2.1.2 A new approach to financial reform

The need for approaching financial reform also in terms of a change in corporate culture has been increasingly highlighted by eminent figures of the financial community. William Dudley, President of the Federal Reserve Bank of New York and Vice-Chairman of the Federal Open Market Committee, in 2014 stated that 'improving culture in the financial services industry is an imperative . . . in order to ensure financial stability over time, but also to ensure the public trust in our financial system'.[243] The Group of 30 in 2015 issued a report providing several suggestions to encourage boards and supervisors to establish sound culture, values,

[241] Winter, n 140.
[242] Graham et al, n 239.
[243] William Dudley, 'Enhancing Financial Stability by Improving Culture in the Financial Services Industry', Remarks at the Workshop on Reforming Culture and Behaviour in the Financial Services Industry, New York Fed, 20 October 2014.

and behaviour, since "problematic cultural norms, and subcultures within large banks, have caused widespread reputational damage and loss of public trust". [244]

A proactive inclusion of cultural and ethical issues in banking supervision has been accomplished by the De Nederlandsche Bank (DNB), which became in 2010 the first banking supervisor globally to treat culture and behaviour as risk factors in supervision (see 2.5.3).[245]

At EU level, the EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)[246] make reference to culture and ethics in banks. Besides providing standards for the evaluation of their business model and strategy, capital, and liquidity adequacy, Title V of the Guidelines provides criteria for the assessment of the internal governance and controls of banking institutions, which should have an "appropriate and transparent corporate structure that is 'fit for purpose' in line with EBA Guidelines on internal governance". Amongst the elements considered, the need is highlighted for a transparent organizational culture, a clear distribution of responsibilities between corporate bodies, an effective communication to all relevant staff, and attention to the institution's ethical corporate and risk culture. Specifically, it is suggested that this should establish an environment of effective challenge in which decision-making processes promote a range of views.

In its final report,[247] among several suggestions, the High-Level Expert Group (HLEG) added the establishment of a corporate culture that considers sustainability issues as key factors. In particular, the report suggests an update of "the 'fit and proper' tests to include an assessment of the individual and collective ability of the members of governing bodies in financial institutions to address sustainability risks, to understand the broader stakeholder context and to take account of clients' sustainability preferences". In order to fulfil their duties, including the duty to evaluate the impact of the business strategy on society and the environment, board members are recommended to participate in specific education and training measures.

Most of the documents and standards just reviewed do not clearly indicate what should be intended by 'culture', nor how to evaluate and measure it. Therefore,

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[244] G30, n 102.
[245] AFM and DNB, n 103.
[246] EBA, 'Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)', EBA/GL/2014/13, 19 December 2014.
[247] HLEG, 'Financing a Sustainable European Economy', 2018, 38–41.

the next section offers an overview of the studies on culture and the measuring methodologies applied within different fields of the social sciences.

### 2.1.3 Culture and morals: an ethical perspective

Before defining culture and suggesting how to implement a sound culture which constrains illicit behaviour and fraudulent phenomena, the ethical approach on which this Part is based is briefly explained. For centuries, moral philosophers have tried to address questions like: What is justice? What kind of behaviour can be claimed to be fair? Nowadays they are still struggling to solve them. This thesis, does not intend to give conclusive answers to those issues, nor to cope with complex philosophical questions. Rather, it follows an approach developed by virtue ethicists.

Confucius was perhaps the first philosopher to have built his view on moral virtues, whereas in Western culture Aristotle's 'Ethica Nicomachea' notably laid the foundation for modern virtue ethics.[248] In opposition to moral models based on universal principles—such as Kant's deontological approach—or utility maximization—developed in Adam Smith's and utilitarian philosophers' theories—virtue ethicists do not intend to identify all-inclusive rules that should shape human behaviour, since there are no such fixed and reliable rules. Rather, moral virtues and sound character offer some practical guiding criteria to face complex reality.[249]

According to Aristotle, well-being, the so-called *eudaimonia*,[250] can be achieved only through a virtuous life. And a virtuous life is defined as an existence conducted in accordance with the essential function of human nature, which is being sociable and rationale.[251] Virtues, which can be divided into soul-related moral virtues (courage, temperance, liberality, magnificence, magnanimity, gentleness,

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[248] *See*, among others: Gertrude E M Anscombe, 'Modern Moral Philosophy', in Roger Crisp and Michael Slore (eds) *Virtue Ethics*, Oxford University Press, 1997, 26–44; Philippa R Foot, 'Virtues and Vices' in Roger Crisp and Michael Slote (eds), *Virtue Ethics*, Oxford University Press, 1997, 163–77; Craig Walton, 'Character and Integrity in Organizations: The Civilization of the Workplace', Business and Professional Ethics Journal, (2001), 20, 105–28; Alasdair MacIntyre, *After Virtue*, University of Notre Dame Press, 3rd ed, 2007); Geoff Moore, 'Humanizing Business: A Modern Virtue Ethics Approach', Business Ethics Quarterly (2005), 15, 237–55; and Edwin M Hartman, *Virtue in Business. Conversations with Aristotle*, Cambridge University Press, 2013.

[249] Hartman, n 248, 9–11.

[250] Many studies use Aristotle's concept of *eudaimonia*, which has been translated into 'happiness', 'flourishing' or 'well-being. See, e.g., Thomas Nagel, 'Aristotle on Eudaimonia', Phronesis (1972), 17, 252–59;William J Prior, 'Eudaimonism and virtue', Journal of Value Inquiry, 35, 325–42.

[251] Aristotle, *Ethica Nicomachea*, Clarendon Press, 1894, Book I, Ch 7.

friendliness, truthfulness, wittiness, and justice) and intellectual-based virtues (art, knowledge, practical judgment, wisdom, and intellect) — and lay in the mean between two vices, excess and defect—[252] can be mastered only by constant training and experience. In other words, virtue manifests itself in action and, as a skill, requires both practice and rational deliberation.[253] Practical wisdom, for instance, can help solve dilemmas deriving from apparent conflicting values and principles. According to this approach, immoral and irrational behaviour derives from a failure of perception and/or a weakness of will, problems solvable by constant and correct training.

MacIntyre, one of the best known virtue ethicists, defines virtues as "dispositions not only to act in particular ways but also to feel in particular ways", and states that to act virtuously 'is to act from inclination formed by the cultivation of the virtues'.[254] However, building on Aristotle's philosophy, he condemns capitalism and businesses as they 'provide(s) systematic incentives to develop a type of character that has a propensity to injustice',[255] while Moore has developed the idea that business character can be trained towards the achievement of internal goods and, as a consequence, applies MacIntyre's notions to business organizations.[256] In particular, Moore distinguishes between virtues and values, as 'valuing is something we do, while virtues are something we have (or not)'. Specifically, virtues are tools that are trained in order to live according to specific values, since 'it takes courage not to tell a lie' and 'it takes temperance to say "No" to a bribe'.[257]

In the last decade, this vision has been confirmed by the social sciences and neuroscientific research in particular, which study individual, organizational, and economic phenomena by looking for more than universal principles, common practices, and behaviours.[258] In line with this approach, Hartmann's Aristotle-oriented lessons to businesses are espoused.[259] Rather than following strict rules and principles, people should develop virtues always with practical wisdom, which is

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[252] Hartman, n 248, 9–11.
[252] Aristotle, n 251, Chapter 8.
[253] Hartman, n 248, 9–11.
[254] MacIntyre, n 248, 149.
[255] Alasdair MacIntyre, *Marxism and Christianity*, Duckworth, 1995, XVI.
[256] Geoff Moore, 'On the Implications of the Practice-Institution Distinction: MacIntyre and the Application of Modern Virtue Ethics to Business', Business Ethics Quarterly, (2002) 12, 1, 19–32.
[257] Moore, n 248, 237–55.
[258] The following sections cover this issue in more detail.
[259] Hartman, n 248, 249–50.

endowed with the flexibility and creativity needed in each situation. Moreover, individual interest and collective interest do not necessarily conflict, while dialectics can enhance ethical thinking.

### 2.1.4 Defining Culture

"As regulators focus on culture, Wall Street struggles to define it" was the heading of an article in *The Wall Street Journal*,[260] which went on, stating: "culture is the buzzword of the moment at banks and a puzzle that regulators and Wall Street firms are wrestling to solve".

Also in the social sciences, despite the rich body of studies on culture developed over a relatively long period of time, the slippery nature of this concept has made it difficult to reach a common definition.[261]

The term 'culture' derives from the Latin 'còlere' whose meaning indicates the cultivation of the soil. The first modern definition of culture was given by the British anthropologist Edward Tylor in 1871,[262] according to whom culture is "that complex whole which includes knowledge, belief, arts, morals, law, custom, and any other capabilities and habits acquired by man as a member of society". In the twentieth century, anthropologists analysed the concept of culture in an attempt to make its definition more precise. The so-called evolutionary/ecological theories viewed culture as all those means that serve human communities adapting to their ecological surroundings.[263] The attention later moved to a semiotic notion of culture,[264] focused on language and symbols. Kroeber and Kluckhohn,[265] in particular, wrote that "culture consists of patterns, explicit and implicit, of and for behaviour acquired and transmitted by symbols, constituting the distinctive achievements of human groups, including their embodiments in artefacts".

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[260] Emily Glazer and Christina Rexrode, 'As Regulators Focus on Culture, Wall Street Struggles to Define It', Wall Street Journal, 1 February 2015, http://www.switchtocommunity.com/article/912-as-regulators-focus-on-culture-wall-street-struggles-to-define-it accessed 20 October 2018.

[261] Two anthropologists, Krowber and Kluckhohn, found 164 definitions of culture. *See* Alfred L Kroeber and Clyde Kluckhohn, *Culture: A Critical Review of Concepts and Definitions*, Peabody Museum of American Archaeology, 1952, 35.

[262] Edward B Tylor, *Primitive culture*, J Murray, 1871, 1

[263] *See* Lewis R Binford, 'Post-Pleinstocene adaptations' (1968), in Sally R Binford and Lewis R Binford. (eds) *New Perspectives in Archaeology*, Aldine, 1968, 373

[264] Bruce M Tharp, 'Defining "Culture" and "Organizational Culture": From Anthropology to the Office (2009), Haworth, available at http://www.haworth.com/en-us/knowledge/workplace-library/documents/defining-culture-and-organizationa-culture_5.pdf accessed 30 October 2018.

[265] Kroeber and Kluckhohn, 261, 35.

As organizational culture studies emerged and developed in the 1980s,[266] anthropologic theories were applied to investigate organizational environments.[267] In 1996, Lundy and Cowling offered a well-known definition of culture as "the way we do things around here".[268] A more structured definition was given by Schein,[269] as "a pattern of shared basic assumptions that was learned by a group . . . that has worked well enough to be considered valid and, therefore, to be taught to new members as the correct way to perceive, think, and feel in relation to problems".[270] The same view of culture as a collection of shared values and norms accepted by a given group was shared by Pettigrew,[271] O'Really, and Chatman,[272] and Brown.[273] Some scholars described it as the software of an organization, a sort of "collective programming of the mind that distinguishes the members of one group or category of people from others".[274]

Even though definitions of culture are numberless, Hofstede in 1990[275] identified some common traits, describing culture as: (i) holistic; (ii) historically

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[266] For the literature on organizational culture, *see*, among others, Allan A Kennedy, and Terrence E Deal, *Corporate Cultures as the Rites and Rituals of Corporate Life*, Addison-Wesley, 1982; Robert H Waterman, Jr and Tom Peters, *In Search of Excellence: Lessons from America's Best-Run Companies*, Harper & Row, 1982; Cary L Cooper, and Sue Cartwright, 'The Role of Culture Compatibility in Successful Organizational Marriage', Academy of Management Executive (1993), 7, 2, 57–70; Kim S Cameron and Robert E Quinn, *Diagnosing and Changing Organizational Culture*, Prentice Hall Series in Organizational Development, 2011.

[267] For a detailed review of some cultural theories developed by anthropologists, see Roger M Keesing, 'Theories of Culture', Annual Review of Anthropology (1974), 3, 1, 73–97.

[268] Olive Lundy and Alan Cowling, *Strategic Human Resource Management*, Routledge, 1996, 168.

[269] Edgar Schein, *Organizational Culture and Leadership*, Jossey-Bass, 2004, 17.

[270] In literature, the term 'climate' is often used, and sometimes confused with the term 'culture'. However, 'climate' refers to how things are, whereas culture concerns why things are the way they are. For a definition of climate, *see* Arnon E Reichers and Benjamin Schneider, 'Climate and Culture: An Evolution of Constructs', in Benjamin Scheider (ed), *Organizational Climate and Culture*, Jossey Bass, 1990, 5–39, and Michael W Grojean et al, 'Leaders, Values, and Organizational Climate: Examining Leadership Strategies for Establishing an Organizational Climate regarding Ethics', Journal of Business Ethics (2004), 55, 3, 223–41. For a further explanation on the difference between the two concepts, see Daniel R Denison, 'What is the Difference between Organizational Culture and Organizational Climate? A Native's Point of View on a Decade of Paradigm Wars', The Academy of Management Review (1996), 21, 3, 619–54.

[271] Andrew M Pettigrew, 'On Studying Organizational Cultures', Administrative Science Quarterly (1979), 24, 4. Pettigrew conceives culture as the system of publicly and collectively accepted meanings operating for a given group at a given time. It is constituted of several concepts: symbol, language, ideology, belief, ritual, and myth.

[272] Charles A O'Reilly and Jennifer A Chatman, 'Culture as Social Control: Corporations, Culture, And Commitment' (1996), in Barry M Staw, Larry L Cummings (eds), *Research in Organizational Behaviours*, 1996, JAI Press, 18, 157–200, 166. According to the authors, corporate culture is 'a system of shared values that define what is important, and norms that define appropriate attitudes and behaviours for organizational member'.

[273] Andrew Brown, *Organizational Culture*, Pitman, 1995, 9, 33, 176.

[274] Geert Hofstede, *Cultures and Organizations: Software of the Mind*, McGraw-Hill, 1991, 4.

[275] *See* Geert Hofstede, *Culture's Consequences: International Differences in Work-Related Values*, Sage, 1980 and Geert Hofstede, 'Measuring Organizational Cultures: A Qualitative and Quantitative Study across Twenty Cases', Administrative Science Quarterly (1990), 35, 1, 286–316.

determined; (iii) related to anthropological concepts; (iv) socially constructed; (v) soft; and (vi) difficult to change. This last trait derives from another common assumption, which resides in the fact that culture is a multilevel concept, made of observable artefacts (visual organizational structure and processes), espoused values (strategies, goals, and philosophies), and basic assumptions (implicit beliefs, perceptions, and feelings).[276] It can be visualized like an onion[277]—the layers of which, from outside in, consist of symbols, heroes, rituals, and values[278]—or an iceberg,[279] the upper visible part of which is made of corporate artefacts, verbal and nonverbal behaviours, while the hidden part consists of basic beliefs, which are tacit and emotionally anchored.[280] As a consequence, any cultural change in the organization should affect all levels, not only common practices—which by themselves reveal little about an institution—but also beliefs and values, which undoubtedly require longer time and a basic genetic compatibility among team members (that is the reason why the hiring function is so decisive).

Economists have developed a different approach to corporate culture since the '90s, linking it to firm performance.[281] For them culture is a means to economic efficiency serving as an informal and flexible tool to cope with new contingencies in a more cost-effective way. Kreps stresses that corporate culture plays a role in firms' game-theoretic interactions involving incomplete contracts, coordination, reputation, unforeseen contingencies, and multiple equilibria.[282] In this respect, corporate culture is useful to the extent that it helps to select among multiple equilibria categorizing unforeseen contingences. By substituting explicit communication[283] and homogenizing beliefs,[284] culture leads to lower monitoring

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[276] Schein, n 269, 25–37.
[277] Hofstede, n 274, 4.
[278] Interestingly, even though values are at the core of the inner human behavioural motivations, shared perceived practices are the key determinants of the company's culture and they are easier to shape. Indeed, values form mostly in early age, in family and school, while practices develop in adult life, generally in the workplace. *See* Waterman, and Peters, n 40.
[279] Sackmann, n 239; and Graham et al, n 239.
[280] Sackmann calls for an in depth study of this hidden part of culture, since looking only at the most superficial part can be misleading. First, because corporate artefacts and behavioural manifestations often reveal nothing about the basic values and beliefs of the firm. Secondly, because same artefacts and manifestations can be found in different organizations, but they do not correspond to the same underlying cultural processes and principles. *See* Sackmann, n 239; and Graham et al, n 239.
[281] *See*, e.g., Hermalin, n 238, 217–61; Guiso, Sapienza, and Zingales, n 238, 23–48; Kotter and Heskett, n 238; Sørensen, n 238, 70–91; Denison, n 238, 83–798.
[282] David M Kreps (1990), 'Corporate culture and economic theory', in James E Alt, Kenneth A Shepsle (eds) *Perspectives on Positive Political Economy*, Cambridge University Press, 1990, 90–143.
[283] Jacques Cremer, 'Corporate Culture and Shared Knowledge', Industrial and Corporate Change (1993), 2, 3, 351–86.

costs, faster coordination, and higher utility.[285] This enables the organization to delegate more effectively[286] by providing—in a sort of hereditary way — "the method, context, values, and language of learning, and the evolution of group and individual competences".

2.1.5 Diagnosing culture

In addition to defining corporate culture, socio-economic studies tried to diagnose it and to understand how it relates to corporate performance. These studies mainly used surveys and interviews, as well as group discussions and participant observation.[287]

As for corporate culture identification, Hofstede did one of the first empirical studies and developed a model based on five dimensions differentiating one national culture from another: (i) power distance; (ii) collectivism versus individualism; (iii) femininity versus masculinity; and (iv) uncertainty avoidance. Two other dimensions have been added later, that is, long-term orientation versus short-term orientation and indulgence versus restraint.[288] This study's ideas have been widely applied with some variations in other researches.[289] Thakor[290] diagnosed culture under the Competing Values Framework (CVF)[291] and identified firm culture along four tendencies: (i) collaborative; (ii) competitive; (iii) control-centred; and (iv) creative, which correspond respectively to: (i) a partnership culture; (ii) a competitive, individual-performance-oriented culture; (iii) a risk-minimization culture; and (iv) a culture focused on product innovation and organic growth. According to Thakor, in order to shape the cultural structure of a firm, one should first be aware of these tendencies, of the intersections between them, and of the fact that the adoption of an approach automatically excludes another. Then the firm

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[284] Of course, this standardizing process is stronger in smaller and older firms, among more important employees, Eric Van de Stein, 'On the Origin of Shared Beliefs (and Corporate Culture)', Ran Journal of Economics (2010), 41, 4, 617–48.
[285] Eric Van de Stein, 'Culture Clash: The Costs and Benefits of Homogeneity', Management Science (2010), 56, 10, 171.
[286] Thakor, n 240.
[287] About the different methods adopted, *see* Sackmann, n 239; and Graham et al, n 239.
[288] Geert Hofstede, Gert Jan Hofstede, and Michael Minkov, *Cultures and Organizations: Software of the Mind*, Rev 3rd ed, McGraw-Hill, 2010, 235–96.
[289] *See*, e.g., the model designed by Paul J Hanges et al, *Culture, Leadership, and Organizations. The Globe Study of 62 Societies*, Sage, 2004.
[290] Thakor, n 240.
[291] Robert Quinn and Kim Cameron, 'Organizational Life Cycles and Shifting Criteria for Effectiveness', Management Science (1983), 29, 1, 33–51.

could hire, train, and allocate resources in accordance with the choice of one cultural model rather than another. If the current actors in the financial sector are analysed, it is immediately apparent that it is almost entirely shaped in terms of competitive culture.

As for the relation between firm culture and performance, the prevailing research claims that 'strong corporate cultures' leads to better firm performance, in line with the economists' belief that high consistency in norms, values, and practices shared in a group leads to better coordination and control. Quantitative analyses have shown that in certain circumstances companies characterized by a strong culture, mostly measured by the consistency of responses to survey items across people, outperformed companies with a weak culture,[292] and have a more stable (less variable) performance in relatively stable environments.[293] Graham et al[294] published another significant empirical study based on an anonymous survey directed to detect how the role of culture was perceived within firms operating in several industries. The results highlighted that culture was considered important with reference to firm performance as well.

However, in almost all studies conducted on both culture diagnosing and on the relationship between corporate culture and performance, only CEOs, CFOs, and managers were interviewed, while other levels of the firm organization were not considered. Moreover, studying only the consistency in corporate behaviour does not give any information on the quality of firm culture. Short-term strategies, illicit behaviour aimed at high profit at any cost became common goals and values in some top executives' perceptions and their firms did not perform in a sustainable way.

It can therefore be suggested that all (levels of) employees' convictions, practices, and opinions should be included in future studies in order to provide a wider and more complete vision of a company profile. Moreover, research studies should also evaluate the quality of the relevant culture, in order to assess its sustainability towards companies' stakeholders in the long run.

[292] Denison, n 238; Gordon and Di Tomaso, n 238; Kotter and Heskett, n 238; and Ronald S Burt et al, 'Contingent Organization as a Network Theory: The Culture Performance Contingency Function', Acta Sociologica (1994), 37, 345–70.
[293] Sørensen, n 238, 70–91.
[294] Graham et al, n 239.

# Chapter II

## Tone at the Top:
## Board Composition, Suitability Requirements and Leadership

2.2.1 Introduction. – 2.2.2 Directors' liability. – 2.2.2.1 Directors' civil liability. – 2.2.2.1.1 Beyond Shareholders versus Stakeholders Approach. – 2.2.2.1.2 Duty of care. – 2.2.2.1.3 Business Judgement Rule in banking sector. – 2.2.2.2. Directors' administrative liability. – 2.2.3. Board composition and structure. – 2.2.3.1. Non-executive and independent directors. – 2.2.3.2 Directors' suitability. – 2.2.4 Decision making in the boardroom: diversity. – 2.2.5 Leadership from a cultural perspective. – 2.2.6 The ethical leader.

### 2.2.1 Introduction

A firm's identity is largely shaped by the rules and practices enacted by the person/people who is in charge, the so-called 'leader(s)'. We might call it either 'tone at the top'[295]—if we want to emphasize a leader's statements and appearance—or 'character at the top'[296] focusing on the leader's behaviour. However, there is no doubt that leadership personality, charisma, and authority influence board composition and practices,[297] as well as employees' behaviours and habits at all levels. That is why the hiring processes, training courses, and remuneration schemes were recently put under the spotlight within organizations' dynamics.

The issue of leaders' expertise, competence and integrity has been addressed by EU financial authority, as they are at the centre of the guidelines recently published by jointly ESMA and EBA[298] and the ECB[299]. At the meantime, we should recall that banks board members are directly liable towards the bank and its shareholders, and indirectly towards other stakeholders. Given the impact of

[295] William C Dudley, Remarks at the workshop on 'Reforming Culture and Behaviours in the Financial Services Industry', Federal Reserve Bank of New York, New York City, 20 October 2014.
[296] Thomas C Baxter, 'The Rewards of an Ethical Culture', Remarks at the Bank of England, London, 20 January 2015.
[297] Gary Abrahams, Joanne Horton, and Yuval Millo, 'The Dynamics of Managerial Entrenchment: The Corporate Governance Failure in Anglo-Irish Bank', 2017, available at https://ssrn.com/abstract=2955610 accessed 2 November 2018.
[298] ESMA and EBA, n 100.
[299] ECB, n 99.

misconduct in financial sector, many scholars even support the idea of enlarging directors' liability by restricting the scope of business judgement rule (BJR).

In this Chapter, I discuss director's liability and BJR scope in banking sector, introduce board composition issues, and analyse some specific criteria taken into consideration by financial authorities during board suitability assessments. The Chapter then focuses on specific organizational and cultural factors, already analysed by social and management studies, that deeply shape and influence the culture of the firms, and that specifically relate to the role of leadership.

### 2.2.2 Directors' liability

As already described, the corporate governance of banks has been one of the most developed areas subject to the process of harmonization within the European Banking Union. However, the same effort has not been placed for the creation of sanctioning systems that are able to promote a uniform compliance to rules.

EU institutions have to deal with many challenges. First of all, banks' directors are subject to both common corporate law and banking law. Therefore, they can incur in both civil and administrative liability (and sanctions). Moreover, the strong autonomy attributed to Member States may lead to fragmentation. From a civil perspective, dissimilarities may derive from differing judicial approaches to the evaluation of directors' breach of fiduciary duties. From an administrative perspective, discrepancies can be detected by simply confronting general and abstract rules.

#### 2.2.2.1 Directors' civil liability

From a civil point of view, we can identify two types of fiduciary duties for corporate officers and directors: the duty of care and the duty of loyalty. However, before analysing in depth the content of these duties, we should first analyse which kind of interests directors should strive to serve, and therefore give an overview of the conflict between the 'shareholders primacy' approach and 'stakeholder theory'.

#### 2.2.2.1.1 Beyond Shareholders versus Stakeholders Approach

The theoretical conflict between shareholder primacy and stakeholder theory has been subject to a long-standing debate, and it ultimately deals with the purpose and role of corporations in the society. According to the shareholder primacy view, directors should solely serve shareholders' interest, and their decisions should focus primarily on shareholder wealth maximization.[300] On the contrary, the stakeholder theory argues that, since other stakeholders – such as employees, suppliers, creditors and the society – are greatly impacted by corporate decisions and practices,[301] directors should consider all stakeholders' interests and act to safeguard the long term stakes of each group. The underlying assumption on which the theory is based is that "boards exist not to protect shareholders per se, but to protect the enterprise-specific investments of all the members of the Corporate "team", including shareholders, managers, rank and file employees, and possibly other groups, such as creditors".[302] Even though many academics heavily criticized shareholder primacy theory and embraced stakeholder theory,[303] shareholder primacy was widely supported by most of financial scholars.[304]

A trade-off between the two approaches was theorized by Jensen in his "enlightened shareholder theory" (see also Section 2.4.4.2), according to which shareholders' value maximization on the long-term cannot be ensured by ignoring or mistreating other stakeholders, since "we cannot create value without good

[300] The most prominent supporter of this theory is Milton Friedman Milton Friedman, who argued in the pages of the *New York Times* Sunday magazine that because shareholders "own" the corporation, the only "social responsibility of business is to increase its profits." However, before him, in 1930s, Berle stated that the "all powers granted to a corporation or to the management of a corporation … [are] exercisable only for the ratable benefit of shareholders". See Adolph A. Berle, 'Corporate Powers as Powers in Trust', 45 Harv. L. Rev. (1932), 45, 1049, 45. The theory has been approached also in relation to the banking sector, *see* Hamid Mehran, Alan Morrison and Joel Shapiro, 'Corporate Governance and Banks: What Have We Learned from the Financial Crisis?', Federal Reserve Bank of New York, Staff Report no. 502/2011, 4.
[301] The main representative of this theory is Freeman. *See* Edwards R Freeman & John McVea, 'A Stakeholder Approach to Strategic Management', Darden Business School Working Paper No. 01-02, available at https://ssrn.com/abstract=263511 or http://dx.doi.org/10.2139/ssrn.263511, accessed 3 November 2018. However, before them, Merrick Dodd, opposing to Berle's shareholder approach, favoured a view of the business corporation as an economic institution which has a social service as well as a profit-making function." Edwin Merrick Dodd, 'For Whom are Our Corporate Managers Trustees?', Harv. L. Rev. (1932), 35, 1144, 1148.
[302] *See* Margaret M Blair, Lynn A Stout, 'A Team Production Theory of Corporate Law', Virginia Law Review (1999), 85, 2, 248-328.
[303] *See*, for a review of stakeholder literature, André O. Laplume, Karan Sonpar, Reginald A. Litz, 'Stakeholder Theory: Reviewing A Theory That Moves Us', Journal of Management (2008), 34.
[304] *See* Shleifer & Vishny, n 7; and Jean Tirole, *The theory of Corporate finance*, Princeton University Press, 2006, Chapter 1.

relations with customers, employees, financial backers, suppliers, regulators and communities".[305]

This is even more true for banking sector, considered the systemic risks related to banking activity and the well-known need to ensure a stronger protection for stakeholders, especially debtholders. Recently, in line with this view, the enlightened shareholder theory developed – in financial sector – into the new notion of long-term value creation, involving the company ambition "to optimise its financial, social and environmental value in the long term",[306] as well as to pursue not only shareholder value but instead shareholder welfare. This means that shareholders should internalize the externalities that are usually internalized by stakeholders.[307] Lipton theorized this emerging corporate governance framework as a New Paradigm,[308] which considers corporate governance as "a collaboration among corporations, shareholders and other stakeholders working together to achieve long-term value and resist short-termism", where institutional investors, in line with their stewardship role, assist the board, CEO and management team in refusing to follow short-term value maximization without considering the impact on the long term.

While the EU law does not clearly adhere to a specific theory or approach. Indeed, the EU Commission in the 2011 Green Paper[309] gave a definition of corporate governance that is not but a compromise between shareholder and stakeholder theory, on the contrary, the BCBS leaned towards the stakeholder theory. This is apparent in its Guidelines[310] at §2 – according to which "the primary

[305] Michael C Jensen, 'Value maximization, stakeholder theory and the corporate objective function', Journal of applied corporate finance (2001), 14, 3, 16.
[306] Dirk Schoenmaker & Willem Schramade, 'Investing for Long-Term Value Creation', Erasmus Platform for Sustainable Value Creation Working Paper 1/2018, available at https://ssrn.com/abstract=3248912 or http://dx.doi.org/10.2139/ssrn.3248912, accessed 4 November 2018. See also Thomas Dyllick & Katrin Muff (2016), 'Clarifying the meaning of sustainable business introducing a typology from business-as-usual to true business sustainability', Organization and Environment (2016), 29, 2, 156-74; Jean Tirole, *Economics for the Common Good*, Princeton University Press, 2017; and Dirk Schoenmaker, 'A Framework for Sustainable Finance', CEPR Discussion Paper, DP12603/2018.
[307] Oliver Hart & Luigi Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value', CEPR Discussion Paper, DP12186/2017.
[308] Martin Lipton, 'The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth', International Business Council Of The World Economic Forum (2016).
[309] See EU Commission, Green Paper: The EU corporate governance framework' (2011), COM(2011) 164 final. In particular, corporate governance is defined as 'the system by which companies are directed and controlled and as a set of relationships between a company's management, its board, its shareholders and its other stakeholders'.
[310] BCBS, n 71, §2 and 20.

objective of corporate governance should be safeguarding stakeholders' interest in conformity with public interest on a sustainable basis" – and at §20 – that states that "the suitability of the appointed board member is as critical as their awareness of the responsibility to look after the interests of the bank as a whole, not just of the shareholders".

Although claiming that stakeholders' interests should be taken into consideration by banks board is now indisputable, especially after the financial crisis, the way to concretely internalize stakeholders' interests in the board's decision-making process is more complicated. In a well-known paper, Hopt[311] criticized various proposals made by scholars. First, introducing labour representatives in the board (like in the German codetermination model) might sound reasonable since workers are interested in the stability of the bank. However, practice reveals that workforce is usually only concerned of maintaining and improving wages and working conditions, even at the expense of a proper risk-taking. As to the idea of including representatives of the deposit insurer or of the bank supervisor in the board of the bank, the solution is troublesome as well, since it would imply both a dangerous political influence on the bank and the co-responsibility of supervisors for bad decisions. In relation to the suggested usage of constituency clauses, the author objects that these proved ineffective in determining better risk-taking, since they leave to the board the full discretion in how to weight the interests involved, and ultimately favour stakeholders' interests only when not conflicting with management interests. The author rejects also the US proposal to make directors liable towards debtholders, since it would not fit with EU private enforcement system. Other more radical solutions – such as denying limited liability to banking industry – should be excluded according to Hopt's view. The author finally concludes – and I espouse his view – that there is "no single safe way to ensure good corporate governance of banks", but a careful combinations of regulatory and soft law measures should be made, avoiding over regulation.[312]

In conclusion, far from requiring the establishment of the so-called 'stakeholder supremacy', banks' managing bodies should take into account the interests of stakeholders, especially depositors and other debtholders.[313] To do that, however, a structural change of the culture of banking institutions is needed, and

[311] Hopt, n 25, 10-14.
[312] *Ibid.*
[313] Macey & O'Hara, n 25, 91–107; and Mullineux, n 44, 375-382.

the change should involve – as I explain further - especially the selection, training and compensation of individuals holding a leading position in the bank, as a board member or senior manager.

#### 2.2.2.1.2 Duty of care

In relation to the specific content of bankers' fiduciary duties, I here limit my analysis to the duty of care. The identification of breaches of the duty of loyalty is indeed difficult, especially considered the typical opacity and complexity characterizing banks activities.

The duty of care requires that directors manage the company with reasonable care, prudence, and diligence. For the specific case of EU, even though some commentators suggested that the scope of fiduciary duties should be expanded in the case of banks, by requiring directors to be held liable in a higher number of cases,[314] the actual proposal has been rejected by the vast majority of the respondents to the Green Paper on Corporate Governance of Financial Institutions.[315] In fact, this expanded liability would translate into an excessive risk-adverse decision-making and would discourage ideal candidates from taking the position, considered the excessive amount of related responsibilities.

However, according do some scholars,[316] CRD IV appears to have already increased the risk for bank directors to be considered liable, and as a consequence, to pay damages or face administrative sanctions. In particular, the directive provides that each "member of the management body shall act with honesty, integrity and independence of mind to effectively assess and challenge the decisions of the senior management where necessary and to effectively oversee and monitor management decision-making".[317]This vague provision would enlarge the number of cases where the directors may be considered liable for failing in adequately exercise their monitoring duties on senior managers' decisions.

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[314] Macey & O'Hara, n 25, 91

[315] Feedback Statement– Summary responses to Commission Green Paper on Corporate Governance in Financial Institutions, 18. *See* also Hopt, n 25, 56.

[316] Luca Enriques & Dirk Andreas Zetzsche, 'Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirement Directive', European Corporate Governance Institute (ECGI) - Law Working Paper No. 249/2014, available at https://ssrn.com/abstract=2412601 or http://dx.doi.org/10.2139/ssrn.2412601, accessed 15 November 2018

[317] CRD IV, Article 91(8).

In line with CRD IV,[318] the EBA further clarified notions of "honesty", "integrity" and "independence of mind". The concepts of "honesty" and "integrity" are associated with good reputation requirements, and basically concern the evaluation of existing criminal or administrative records or investigations regarding the directors.[319] This suggests that the related provision in CRD IV is not but an explication of duties board members implicitly already had. The same cannot be said with reference to the independence of mind requirement. This concerns not only the presence of conflicts of interests, but also the fact that board members should have "necessary behavioural skills", that include:[320] (a) the courage, conviction and strength to effectively assess and challenge the proposed decision of other directors, (b) the ability to ask questions to other directors, and (c) the capability to resist 'group-think' phenomenon. During the assessment, the actual past and on-going behaviour of the assessed board member, especially within the institution, should be considered.[321] This would translate in the assessment of the quality of the director's intervention in the board minutes and ultimately increase their risk of liability. In fact, CRD IV not only requires Member States to provide for administrative penalties if "an institution allows one or more persons not complying with Article 91 to become or remain a member of the management body",[322] but it also specifies that individual board members breaching those duties may be subject to administrative pecuniary penalties of considerable amount,[323] to be published by financial competent authority without delay on their official websites.[324] As accurately argued by Enriques and Zetzsche,[325] it would not be difficult for supervisory authorities finding, in case of harmful decision-making by the managers of the institution, that a member of the board did not properly exercise those "necessary behavioural skill".

If we combine these provisions with those concerning the specific suitability of board directors, that legally require them a greater financial expertise and

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[318] Pursuant to article 91(12)(c) of the CRD IV, EBA will have to provide guidelines on "the notions of honesty, integrity and independence of mind of a member of the management body as referred to in paragraph 8."
[319] ESMA and EBA, n 100, §73-78.
[320] *Id*, §82.
[321] *Id*, §83.
[322] CRD IV, Article 67(1)(p).
[323] Up to EUR 5,000,000, or twice the amount of profits gained or lossess avoided because of the breach where those can be determined. See CRD IV, Article 67(2)(f-g).
[324] CRD IV, Article 68.
[325] Enriques & Zetzsche, n 316.

competence compared to those generally required to non-financial companies (see 2.2.3), we can conclude that the directive undoubtedly expands directors duties and liabilities.

However, directors' duty of care cannot be analysed without taking into account its concrete judicial enforcement, especially in relation to the application of the business judgement rule in the banking sector.

#### 2.2.2.1.3 Business Judgement rule in banking sector

Under the Business Judgment Rule, courts presume that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company."[326] Even though the rule was established to avoid the direct interference by courts in business decision-making, in practice the standard left to courts a great discretionary power to determine the conditions under which the protection of the business judgment rule may be available. Notably, national courts applied the business judgment rule with different levels of severity, depending on historical and cultural more than legal reasons.[327]

In relation to banking sector, some scholars argued that the application of the business judgment rule would lead to excessive risk-taking when systemic risks are concerned, because of the typical opacity and complexity of banks.[328] In the authors' opinion, banks directors should be therefore responsible for the level of risk-taking as well as strategy, and not just for complying with legal norms. However, the argument was criticized by other scholars that highlighted how removing or limiting the scope of business judgment rule would be detrimental for entrepreneurship and innovation, since it would excessively discourage risk-taking,[329] and prevent banks' ability to earn returns for investors.[330] Moreover,

[326] *Aronson v Lewis*, 473 A.2d 805, 812 (Del. 1984).
[327] Consider, for instance, the different approached adopted by the Supreme Court of Delaware and the Italian Supreme Court respectively in *In re Citigroup Inc. Shareholders Derivative Litigation* and in the decision No. 27379, 5 february 2013.
[328] John Armour & Jeffrey Gordon, 'Systemic Harms and Shareholder Value', Journal of Legal Analysis (2014), 6, 35.
[329] Ferrarini, n 63.
[330] In thise regard, *see* Court of Chancery, Delaware, in re Citigroup Inc. Shareholder Derivative Litigation, Civil Action No. 3338-CC, February 24, 2009, and Court of Chancery, Delaware, In re

expanded fiduciary duties and liability risk would discourage skilled persons from serving on bank boards.

Finally, as explain below (Section 2.2.2.2), the EU regulation already provides administrative pecuniary penalties in case of breach of fiduciary duties, and therefore there seems not to be a need for corporate law to increase the risk for directors' civil liability.[331]

### 2.2.2.2 Directors' administrative liability

As described in 2.2.1.2, CRD IV assigns to Member States a broad discretionary power as to the power to establish proper administrative penalties and other measures for governance-related breaches regulated under Articles 66 and 67.

We can find other provisions concerning the breach of governance rules within the SSM regulation that attributes to the ECB the power to adopt, in the event of specific circumstances, a series of measures. In relation to corporate governance, the ECB may: (a) require the reinforcement of the arrangements, processes, mechanisms and strategies; (b) require boards to present a plan to restore compliance with supervisory requirements and set a deadline for its implementation; (c) demand institutions to limit variable remuneration as a percentage of net revenue; and (d) to remove members from the management body when not fulfilling the suitability requirements.

The ambiguity of these provisions, combined with the large discretionary power left to Member States, cannot but lead to an inefficient enforcement system. A way to avoid this inefficiency is represented by the establishment of a single enforcement handbook which would integrate the existing single rulebook and single supervisory handbook, bridging the gap between the two in practice.[332] This would make more clear which principles and objectives are pursued by financial supervisors in the exercise of their competence, and give support to the implementation of the common approach to supervision. The establishment of a

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The Goldman Sachs Group, Inc. Shareholder Litigation, Civil Action No. 5215 – VCG, October 12, 2011.

[331] Enriques & Zetzsche, n 316.

[332] Dalvinder Singh, 'The Centralization of European Financial Regulation and Supervision: Is there a need for a Single Enforcement handbook?', *European Business Organization Law Review*, 2015, 5, 439 *et seq.*

single enforcement rulebook would be by no means a challenge, made difficult especially for the dissimilarities among national judicial systems. However, the step is necessary in order to strengthen EU financial integration.

### 2.2.3 Board composition and structure

Board composition and structure has been one of the most debated issues since corporate governance has been studied and formalized in guidelines and standards. With reference to the banking sector, independency and competency requirements, as well as diversity and suitability requirements were the most discussed.

#### 2.2.3.1 Non-executive and independent directors

The role of non-executive and independent directors in the board has been at the centre of corporate governance debate for more than twenty years.[333] The requirement of having independent directors on the board – by mandatory rules or corporate governance codes - is nowadays diffused worldwide,[334] but national regulators have declined it in various ways.[335]

In the EU, the Commission – in its Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board - defined 'independent' a director who "is free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgement".[336] However, the Commission confers to the Member States the task of adopting specific criteria for the assessment of the independence of directors – both by means of laws or corporate governance code – taking into account the guidance

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[333] Paul L Davies & Klaus J Hopt, 'Boards in Europe – Accountability and Convergence', ECGI - Law Working Paper No. 205/2013, 15 *et seq.*

[334] The concept of independent director has its roots in US in '70s as a means to strengthen the board's monitoring role in diffused ownership systems, and later exported to other corporate governance systems, which are generally characterized by concentrated ownership. *See* Jeffrey N Gordon, 'The rise of independent directors in the United States, 1950-2005: Of shareholder value and stock market prices', Stanford Law Review (2007), 59, 1465-568; and Guido Ferrarini and Marilena Filippelli, 'Independent directors and controlling shareholders', Orizzonti del diritto commerciale (2013), I.

[335] Davies & Hopt, n 333, 16-17.

[336] Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, Article 13.

set out in Annex II of the Recommendations. However, the determination of the nature of independence is fundamentally an issue for the (supervisory) board itself to determine. Clearly, the combination of hard and soft law, as well as the different implementation of independency requirements across national governance systems, caused deep divergences in the interpretation of the concept among Member States.[337]

With specific reference to banks, according to the BCBS and the FSB, an independent directors is "a non-executive member of the board who does not have any management responsibilities within the bank and is not under any other undue influence, internal or external, political or ownership, that would impede the board member's exercise of objective judgment".[338] In the EU, a general definition of independence for banking institutions should have been set within the CRD IV, by leaving boards free to adapt it to the specific characteristics of their banks, and make then the chosen solution subject to the ECB assessment. On the contrary, CRD IV does not provide a definition of independency, even though it makes some general reference to it.[339] A more specific definition and description of the independency requirement – conceivably provided in order to distinguish it from the 'independency of mind' requirement – was recently given by EBA and ESMA in the 'Guidelines on the assessment of the suitability of members of the management body and key function holders'.[340]

According to the guidelines, independent members should play a key role in enhancing the effectiveness of checks and balances within the credit institution by improving oversight of management decision-making, and specifically ensure that: (i) all stakeholders' interests are duly taken into account in the discussions and decision making of the board; (ii) board is not dominated by any individual or a small group of individuals; and (iii) conflict of interests are properly managed.

The guidelines then specify that "'being independent' means that a member of the management body in its supervisory function does not have any present or recent past relationships or links of any nature with the CRD-institution or its management that could influence the member's objective and- balanced judgement

[337] See Davies & Hopt, n 333, 15 *et seq.*, and Ferrarini and Filippelli, n 334.
[338] See BCBS, n 71 1, and FSB, *Thematic review on risk governance*, February 2013, ii.
[339] For example, Article 76 of Directive 2013/36/EU establishes 'that the head of the risk management function shall be an independent senior management with distinct responsibility for the risk management function'.
[340] ESMA and EBA, n 100.

and reduce member's ability to take decisions independently".[341] Without prejudice to national requirements, the guidelines suggest setting a required number of independent members that varies based on the principle of proportionality.[342] The guidelines then provide a list of situations in which a member of a bank's management body in its supervisory function is regarded as not 'being independent'.[343] Many situations are clearly drawn from the criteria provided by the Commission Recommendation of 2005 to help the (supervisory) board to determine whether a non-executive or supervisory director may be regarded as independent.[344] However, the guidelines specify that the mere fact of meeting one or more of the listed situations does not automatically qualify a member as not being independent. On the contrary, the interested bank, in the event a member falls under one or more of the situations described, may demonstrate to the competent authority, by giving proper justification, that the member should be considered independent as the situation does not affect his/her ability to "exercise objective and balanced judgement".[345]

The assumption that having independent directors would be concretely beneficial in terms of performance, as it would lead to better monitoring of managers and preventing abuses,[346] was highly criticized.[347] With specific reference to banking sector, scholars excluded the existence of a positive relationship between independency of the board and performance. An empirical study conducted by Adams and Mehran found that the proportion of independent outsiders on the board is not significantly related to performance.[348] Another study by Adams found that banks that received TARP funds had a higher number of independent members in the board compared to other banks.[349]

There is no doubt that the presence of independent directors was not sufficient to prevent financial scandals, and for many reasons.[350] First of all, as independent

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[341] ESMA and EBA, n 100, § 81.
[342] *Id*, § 89.
[343] *Id*, § 91.
[344] Commission Recommendation, n 336, Annex II.
[345] ESMA and EBA, n 100, § 92.
[346] Benjamin E Hermalin & Michael S Weisbach, 'Boards of directors as an endogenously-determined institution: a survey of the economic literature', Econ. Pol. Rev. (2003), 9, 7–26.
[347] Davies & Hopt, n 333, 18-19.
[348] Renée Adams & Hamid Mehran, 'Bank board structure and performance: Evidence for large bank holding companies', Federal Reserve Bank of New York Staff Report no. 330 (2008).
[349] Renée Adams, 'Governance and the Financial Crisis', ECGI - Finance Working Paper No. 248/2009, available at at https://ssrn.com/abstract=1398583, accessed 14 November 2018.
[350] Notably, in Enron's board the majority of members was independent. See Curtis J Milhaupt & Katharina Pistor, *Law & Capitalism*, The University of Chicago Press, 2008, 47 et seq.; John C Coffee, *Gatekeepers: the role of the professions in corporate governance*, Oxford University Press, 2006.

directors usually work part time and are not involved in day-to-day operations, they do not possess a sufficient knowledge of the firm where they serve,[351] and suffer from information asymmetries in respect to managers.[352] Moreover, strict standards of independency make it problematic for companies to select directors having sufficient expertise and knowledge about the firm,[353] and this difficulty is worsened by the limited compensation perceived by non-executives.[354] Considered the complexity of certain banking and financial activities and of the related risks, these weaknesses are particular exacerbated in banking sector.

#### 2.2.3.2 Directors' suitability

The increased complexity of financial products and processes, combined with the new aim to ensure investors' protection and banks' compliance to a massive number of EU rules, enlarged the scope of competences required to banks' directors. This need is even more justified by the fact that the lack of expertise and competence was considered one of the key factors that contributed to the worsening of the crises.[355] However, empirical evidence does not unanimously confirm this argument. For instance, while it is true that the board at Lehman Brothers comprised – among others – a theatrical producer, an actress, the chairman of a pharmaceutical company and three executives of firms operating in the IT, auction and energy sectors,[356] it is also true that more than half of the directors at Bear Stearns was represented by individuals with a banking background.[357] Moreover, the requirement for a large number of outside and independent directors might be one of the main reasons for the lack of specific competences in banking boards.

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[351] Davies & Hopt, n 333, 18-19; Jonathan H Gabriel, 'Misdirected? Potential issues with reliance on independent directors for prevention of corporate fraud', Suffolk U. L. Rev. (2004), 38, 646; Renée B Adams & Daniel Ferreira, 'A theory of friendly boards', J. Finance (2007), 62, 1, 217–250.

[352] Fred Tung, 'The puzzle of independent directors: new learning', B.U.L. Rev. (2011), 91, 1185-1189; 17; Elizabeth Cosenza, 'The holy Grail of corporate governance reform: Independence or democracy?', B.Y.U.L. Rev. (2007), 52.

[353] Kirkpatrick, n 54.

[354] Davies & Hopt, n 333, 18-19; Francesco Guerrera & Peter Thal Larsen, 'Gone by the board? Why bank directors did not spot credit risks', in Financial times, 25 June 2008, https://www.ft.com/content/6e66fe18-42e8-11dd-81d0-0000779fd2ac, accessed 28 November 2018.

[355] See Kirkpatrick, n 54, 10-14.

[356] David F Larcker & Brain Tayan, 'Lehman Brothers: Peeking Under the Board Façade', Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in Corporate Governance No. CGRP-03/2010, available at https://ssrn.com/abstract=1678044, accessed 14 November 2018.

[357] Guerrera & Larsen, n 354.

Regardless of the effective role played by boards' lack of competence before and during the crisis, possessing a good knowledge and expertise in financial – but also non-financial sector – is nowadays considered an essential requirement for board members in order to ensure that banks activities are soundly managed and monitored. The BCBS Guidelines, for example, require boards to possess competence and expertize in relevant areas comprising "capital markets, financial analysis, financial stability issues, financial reporting, information technology, strategic planning, risk management, compensation, regulation, corporate governance and management skills"[358]. Requiring a specific knowledge of information technology, in particular, enhances the quality of monitoring activities, considered that banks' opacity is generally reinforced by complex IT systems. Moreover, having members specialized in various professional areas promotes diversity of views and avoids the consequences of group-thinking. To this end, the Guidelines require directors' to act in a way that facilitates communication, collaboration and critical debate in the decision-making process.[359]

Moreover, the BCBS specifies that board members should be selected taking into account their independence of mind (especially in the case of non-executives), absence of conflict of interests, the circumstances that they have a record of integrity and good repute, sufficient time to carry out their responsibilities and the ability to promote a smooth interaction between board members.[360] Induction and on-going training programs should be established in order to ensure that "board members acquire, maintain and enhance their knowledge and skills".[361] The board should also dedicate sufficient time and resources in performing its responsibilities.[362] The BCBS mandates the supervisory authorities with the task of evaluating the processes and criteria used by banks in the selection of board members, and ensuring their suitability on an on-going basis.

In the EU, as already explained [see Section 1.2.3.2.1(a)], CRD IV followed the BCBS provisions, by requiring boards to possess 'adequate collective knowledge, skills and experience to be able to understand the institution's activities, including the main related risks.[363] Going even further compared to the BCBS guidelines,

[358] BCBS, n 72, §49.
[359] Ib.
[360] BCBS, n 71, §51-52.
[361] Id, §55.
[362] Id, §55.
[363] CRD IV, Art 91(7).

CRD IV establishes a limited number of directorships a member may hold at the same time.[364] Moreover, to promote diversity, it requires that nomination committees should introduce targets for the 'representation of the underrepresented gender' in the board.[365]

CRD IV entrusts the EBA with the development of guidelines to clarify the requirements set out at Article 91, with specific reference to the notions of "sufficient time commitment", "adequate collective knowledge, skills and experience", "honesty, integrity and independence of mind", "adequate human and financial resources devoted to the induction and training of members of the management", and "diversity".[366] The related guidelines,[367] issued in 2018, are addressed to credit institutions,[368] financial holding companies,[369] mixed financial holding companies[370] and investment firms,[371] but also to national supervisory authorities and to the ECB, which should ensure that the specified financial institutions are compliant through a specific assessment process.

In the event the outcome of the assessment concludes that the candidate member is not sufficiently proved to be suitable, the competent authority should alternatively objet or not approve the appointment of that person, "unless the identified shortcomings are remediable and can be overcome by other measures taken by the institution(s)".[372] Moreover, the competent authority can take further measures, from requiring the organization of specific training sessions for board members to the removal of members from the management body or the imposition of administrative penalties or other measures.[373]

The ECB, in drafting its updated version of the 'Guide to fit and proper assessments'[374] follows some of the evaluation criteria at the centre of ESMA and EBA Guidelines, namely reputation, experience, conflicts of interest and

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[364] *Id.*, Article 91(3)(4). See, again Section 1.2.3.2.1(a).
[365] *Id.*, Article 91(2)(a).
[366] *Id.*, Article 91(12).
[367] EBA, n 100.
[368] As define in Article 4(1)(1) of Regulation (EU) No 575/2013.
[369] As define in Article 4(20) of Regulation (EU) No 575/2013.
[370] As define in Article 4(1)(21) of Regulation (EU) No 575/2013.
[371] As define in Article 4(1)(1) of Directive 2014/65/EU.
[372] EBA, n 100, §189.
[373] *Id.*, §191.
[374] ECB, n 99. Fit and proper supervision is one of the fields of competence for which ECB has exclusive responsibility. Article 4(1)(e) of the SSM Regulation makes clear that fit and proper assessments should be part of ECB's supervision of the overall governance of credit institutions. The scope of this guide is obviously stricter than the scope of ESMA and EBA Guidelines, as it covers fit and proper assessment in relation to the boards of significant institution within the Euro area.

independence of mind, time commitment to perform the functions involved and the collective suitability of the board. The guide is not a legally binding document and shall not in any case substitute the relevant legal requirements stemming either from applicable EU law or applicable national law, nor does it introduce new rules or requirements. To the extent possible, the guide follows the terminology used in the CRD IV and the Joint ESMA and EBA Guidelines on suitability and the EBA Guidelines on internal governance.

Given the vast number or criteria designed by the EU authorities for the assessment of board members, my analysis is limited to the diversity requirement, one of the most debated factors from a sociological perspective.

### 2.2.4 Decision making in the boardroom: diversity

As implied by the guidelines issued by EU financial authorities, boards' decision-making should be studied from the perspective of their complex social dynamics. Empirical research should not be limited to the composition of boards and the number of their members, but should extend to the actual functioning of these groups both inside and outside the boardroom.[375] Indeed, the lack of trust between managers and the board, the absence of critical analysis of corporate information by the latter, and the non-consideration by either boards or managers of the claims of whistle-blowers (as shown by the case of Wells Fargo) are common features of many failures and scandals in the financial and non-financial sectors.

Restoring an effective decision making in boards is crucial in order to prevent misbehaviour in financial institutions. Boards should be able to balance the need for trust and collaboration with that for control and constructive conflicts.[376] While a collaborative board may promote the sound and transparent management of an organization, cognitive conflicts[377] involving 'the consideration of more alternatives

[375] See Andrew M Pettigrew, 'On Studying Managerial Elites', Strategic Management Journal (1992), 13, 163–182.

[376] Chamu Sundaramurthy and Marianne Lewis, 'Control and Collaboration: Paradoxes of Governance', The Academy of Management Review (2003), 28, 3, 397–415.

[377] Amason distinguishes between cognitive affective (personal) and cognitive (task-related) conflict. While the former can prevent boards from functioning, the latter improve decision-making processes. See Allen C Amason, 'Distinguishing the Effects of Functional and Dysfunctional Conflict on Strategic Decision Making: Resolving a Paradox for Top Management Teams', Academy of Management Journal (1996), 39, 123–48.

and the more careful evaluation of alternatives'[378] can also be beneficial. Indeed, too much cohesiveness amongst directors may translate into a weak board dominated by an imperial CEO, as shown by the failure of the Anglo Irish Bank.[379]

For these reasons, both CRD IV and the ESMA and EBA guidelines recommend that board diversity should be fostered to the extent that it improves an exchange of views and ideas between the directors.[380] In this regard, recital 60 of CRD IV describes the lack of diversity as the cause of 'group think' phenomenon that lead to weak monitoring by boards, and states that:

> "To facilitate independent opinions and critical challenge, management bodies of institutions should therefore be sufficiently diverse as regards age, gender, geographical provenance and educational and professional background to present a variety of views and experiences. Gender balance is of particular importance to ensure adequate representation of population".

The same notion of diversity is followed in ESMA and EBA guidelines,[381] whereas diversity requirement is not explained in the ECB guide.

If variety in professional experience is undoubtedly fundamental to avoid group-thinking, narrow framing and ethical blindness phenomena (see Section 2.3.3.3), it cannot be asserted the same for the other factors taken into consideration by CRD IV. As for age diversity, for instance, even though some studies found that demographic similarity among board members enhance group-think phenomenon and weak monitoring of managers,[382] the concrete implementation of age diversity provision is quite troublesome. Given that strong competency and experience are essential requirements for members to perform their duties, it is inevitable that board members are close in age. Similar doubts can be raised in relation to the requirement for a diverse geographical provenance of board members. Even though the requisite seems to make sense, especially for institutions that operate internationally, the involvement of different languages and cultures would make information flow more complex and probably reduce the debate within the boardroom.

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[378] Forbes and Milliken, n 217, 489–505.
[379] Abrahams, Horton, and Millo, n 74.
[380] Sundaramurthy and Lewis, n 218, 397–415.
[381] EBA, n 100, §105.
[382] James D Westphan & Adward J Zajacwho, 'Who Shall Govern? CEO/Board Power, Demographic Similarity, and New Director Selection', Administrative Science Quarterly (1995), 40, 1, 60-83.

As for gender diversity, some observed how the impulse to increase the number of female directors in the boards seems to follow political rather than functional reasons.[383] Some studies show that banks have less gender diverse boards than other firms, especially due educational reasons (in particular, gender gaps in math scores).[384] However, studies on the relationship between gender diversity and board effectiveness and firm performance are quite mixed. Even though some scholars found that gender diversity improve some aspects of board behaviour[385] – such as attendance at board meetings – they also found that it is linked to poor firm performance.[386] Moreover, gender diversity would not reduce risk-taking, as argued by Renée Adams and Patricia Funk, as female directors' values differ from women's values in general, and are even more risk-loving than male directors.[387] As to the few empirical studies specifically focusing on the financial sector, the results are again mixed, as some scholars found that firms with more gender-diverse boards were less involved in sub-prime lending,[388] while others found that more diverse boards would be more risk prone.[389]

As a consequence to these arguments, many criticized the EU Commission choice to require the nomination committee to set "a target for the representation of the underrepresented gender in the management body and prepare a policy on how to increase the number of the underrepresented gender in the management body in order to meet that target".[390] Enriques and Zetzsche, for instance, argue that gender diversity could be beneficial in terms of bank's performance and risk-taking,

[383] See Jens Hagebdorff, 'Corporate Governance', in Berger, Molyneux, Wilson (eds), *The Oxford Handbook of Banking, Second Edition*, Oxford University Press, 2014, 150.
[384] Renée B Adams, and Tom Kirchmaier, 'Women in Finance', European Corporate Governance Institute (ECGI) - Finance Working Paper No. 479/2016, available at https://ssrn.com/abstract=2798571, accessed 20 November 2018.
[385] Sabina Nielsen & Morten Huse, 'The contribution of women on boards of directors: Going beyond the surface', Corporate Governance: An International Review (2010), 18, 2, 136– 148.
[386] Renée B Adams & Daniel Ferreira, 'Women in the boardroom and their impact on governance and performance', Journal of Financial Economics (2009), 94, 2, 291-309.
[387] Renée B Adams & Patricia Funk, 'Beyond the Glass Ceiling: Does Gender Matter?', MGMT. SCI (2012), 58, 219, 234; Adams & Ferreira, supra note 45, at 303.
[388] Maureen I Muller-Kahle & Krista B. Lewellyn, 'Did board configuration matter? The case of US subprime lenders', Corporate Governance: An International Review (2011), 19, 5, 405–417.
[389] Allen N Berger, Thomas Kick & Klaus Schaeck, 'Executive board composition and bank risk taking', Deutsche Bundesbank Working Paper No. 3/2012. However, another study found opposite results, i.e. a negative relation between women's presence in boardrooms and risk-taking measures (loan loss reserves, loan loss provisions and impaired loans ratio). See Mohamed Azzim Gulamhussen & Sílvia Fonte Santa, 'Women in Bank Boardrooms and Their Influence on Performance and Risk-Taking', Global Finance Journal (2015), 28, 10-23.
[390] CRD IV, Article 88 (2).

but only in relation to the specific circumstances of each bank and of each market for bank directorships.[391]

It should be observed that also in the organizational psychology literature, board diversity in general was broadly discussed, and empirical research seems to have found no positive relationship between diversity and board performance.[392] Lau and Murnighan even tried to rationalize potential negative effects of demographic diversity on the basis of the notion of 'faultlines',[393] that would lead to the creation of sub-groups and therefore to conflicts. 'Faultlines' "divide a group's members on the basis of one or more attributes" such are gender, race or age.[394] Like the faults in the earth's crust, that can go unnoticed for many years, before suddenly generating an earthquake, group faultlines can lead to conflicts between subgroups. Interestingly, the authors found that moderate group diversity would generate strong faultiness and therefore conflicting subgroups, while very diverse group would perform better and show more social integration.[395] Other scholars also noted that when diversity is factional (i.e. board members are representatives of stakeholder factions), diversity is likely to affect decision-making leading to conflicting management, but would not reflect individual perspectives.[396] Diversity, in other words, is more complex than how implied by regulators, and could reveal ineffective in building better functioning boards.

We can conclude that promoting diversity – especially in terms of professional background and education – can be beneficial to enhance debate within the boardroom and avoid groupthink phenomenon, provided it is founded on reciprocal trust and common values. However, establishing strict diversity requirements in terms of gender, age and geographical provenance could increase the risk of high board fragmentation without effective benefits in terms of board monitoring. As group dynamics are complex and the effects of diversity may differ in relation to diverse circumstances, EU authorities should avoid setting out too

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[391] Enriques & Zetzsche, n 316.
[392] For a review, see Jakob de Haan & David-Jan Jansen, 'Corporate Culture and Behaviour: A Survey' De Nederlandsche Bank Working Paper No. 334/2011, 6, available at https://ssrn.com/abstract=1979326, accessed 16 November 2018.
[393] See Dora C Lau & J. Keith Murnighan, 'Demographic diversity and faultlines: The compositional dynamics of organizational groups', Academy of Management Review (1998), 23, 2, 325-340.
[394] *Id.*
[395] Dora C Lau & J. Keith Murnighan, 'Interactions within groups and subgroups: The effects of demographic faultlines', Academy of Management Journal (2005), 48, 4, 645-659.
[396] Dennis Veltrop, Niels Hermes, Theo Postma, & Jakob de Haan, 'A tale of two factions: Exploring the relationship between factional faultlines, conflict management and the moderating role of reflexivity in pension fund boards', SOM Research Report 12001/2012.

much detailed criteria, and rather leave boards the power to exercise their autonomy.

### 2.2.5 Leadership from a cultural perspective

In order to get a full comprehension of how board candidates and key function holders behave and which ethical profile they should have in order to ensure a sound corporate culture, we should first try to realize when, how and why they misbehave.

Since leaders design the 'soul' of an organization by transmitting their values and beliefs to the corporate structure,[397] they can also encourage their subordinates to carry out unethical behaviour[398] by sending messages that influence their readiness to comply with legal and/or ethical standards.[399] It is enough here to consider the case of John Gutfreund, CEO of Salomon Brothers, whose "leadership led to a culture that was tailor-made for greedy and power-hungry employees whose commitment to ethical behaviour was suspect".[400] Gutfreund sent very clear but wrong messages to his employees by rewarding aggressiveness and linking the incentive system to the bank's short-term performance. He reacted to crises in the organization by covering-up illicit behaviours and made betrayal the key to his success in the company.[401] His policies for promoting and firing employees were vague. As a result of this leadership and management style, Salomon Brothers ran into what became known as the Treasury bond scandal of the '90s.[402]

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[397] See, e.g., Van de Stein, n 284, 617–48, and Schein, n 269, 25–37.
[398] See, Lo, n 240, 18; Ronald R Sims and Johannes Brinkman, 'Leaders as Moral Role Models: The Case of John Gutfreund at the Salomon Brothers', Journal of Business Ethics (2002), 35, 4, 327–39; and Lorenzo Patelli and Matteo Pedrini, 'Is the tone at the top associated with financial reporting aggressiveness?', Journal of Business Ethics (2015), 126, 1, 3–19.
[399] Tom R Tyler and Steven L Blader, 'The Group Engagement Model: Procedural Justice, Social Identity, and Cooperative Behaviour', Personality and Social Psychology Review (2003), 7, 349.
[400] Sims & Brinkman, n 398, 327–39.
[401] He sold the company to Philip Brothers without even telling to the owner of the Salomon Brothers, Billy Salomon. See Sims & Brinkman, n 398, 327–39.
[402] In 1991, John Gutfreund, John Meriwether (President of the Salomon from 1986 to 1991), and Thomas Strauss (Vice Chairman of the Salomon) went under SEC investigation (No 3-7930) for violation of their supervisory responsibilities on firm employees. In particular, after being informed by Donald Feuerstein, the firm's chief legal officer, about the submission of false bids in US Treasury Securities by Paul Mozer, the head of the firm's Government Trading Desk, they did not take action and did not report the information to the government.

Dysfunctional leadership also characterized the history of Deutsche Bank in the last two decades and the scandals in which it was embroiled.[403] The cultural shift from the traditional German bank to an Anglo-American style investment bank after 1994 provoked an identity crisis, which resulted in the appointment of an all-powerful CEO, Josef Ackermann, and of senior managers like Edson Mitchell, who once introduced himself as 'God', in addition to many traders hired directly from the United States.[404] Wrongly incentivized employees, a weak compliance function, inadequate risk management, and lack of internal controls created the perfect conditions for the bank to take part in many illicit and abusive practices.[405]

Wells Fargo and its Chairman and Chief Executive Officer John Stumpf offer another meaningful example. The latter managed the bank according to the 'Gr-Eight' philosophy,[406] setting up a high-pressure environment, which ultimately led first-line employees to open more than two million fake accounts. The toxicity of the bank's corporate culture was so deeply engrained that during his testimony before the House's Financial Services Committee Stumpf claimed, with no shame nor sense of guilt, that he 'care(ed) about outcomes, not process'.[407] It is no wonder that it was then reported that many employees had been fired after speaking-up about the unethical practices carried out within the firm, and that a petition, signed by five thousands employees, had just been ignored during the years preceding the outbreak of the Wells Fargo scandal.[408]

The topic of the 'imperial CEO' has been largely studied by scholars in the last decades.[409] It is worth noticing in this regard that a recent judgment of the Milan Tribunal[410] upheld the decision of an international company leader in the insurance brokerage and risk-management sectors, to fire its CEO because of the corporate

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[403] Ullrich Fichtner, Hauke Goos, Martin Hesse, 'The Deutsche Bank Downfall. How a Pillar of German Banking Lost Its Way', Spiegel Online, 28 October 2016, available at http://www.spiegel.de/international/business/the-story-of-the-self-destruction-of-deutsche-bank-a-1118157.html accessed 18 November 2018.

[404] *Ibid.*

[405] *Ibid.*

[406] This was the bank's internal goal of selling at least eight different financial products to each customer; see Suzanne Mc Gee, 'Wells Fargo's toxic culture reveals big banks' eight deadly sins', The Guardian, available at https://www.theguardian.com/business/us-money-blog/2016/sep/22/wells-fargo-scandal-john-stumpf-elizabeth-warren-senate, accessed 18 November 2018.

[407] Ochs, n 230.

[408] *Ibid.*

[409] Brian R Cheffins, 'The Corporate Governance Movement, Banks and the Financial Crisis', ECGI Law Working Paper No 232/2014; University of Cambridge Faculty of Law Research Paper No 56/2013, available at https://ssrn.com/abstract=2365738, accessed 20 November 2018.

[410] Tribunale di Milano, No 10334/2014 R G, Uberto Ventura c Aon Global Emea.

climate he had built in the company — which was described as 'unnecessarily authoritarian' and 'de-motivating', while abuse of power and of competencies were the rule — despite the fact that he had led the company to huge profits and to a better market position than previously.

Those just reported are simply a few examples of rotten practices at financial institutions which were widely acknowledged by policymakers and supervisors in their recent statements and reports. Sutherland[411] was the first scholar to acknowledge that criminal offences committed by white-collars workers are as frequent as the crimes committed by lower-class individuals, but less prosecuted and punished than the latter. In his opinion, the reaction of society and even of the crime perpetrators once convicted seemed to be rather weak considering the serious consequences produced by the same; which sounded as absurd given that 'the financial cost of white-collar crime is probably several times as great as the financial cost of the crimes which are customarily regarded as the crime problem'.[412] A possible explanation is that the lack of physical harm and the 'abstractness' of the crime make us perceive these kinds of offences as different,[413] which can also explain the lack of guilt that offenders feel after being convicted.

A rich literature links bad leadership to bad firm performance.[414] Managerial over-optimism, overconfidence, dominance, narcissism, arrogance, self-absorption, and miscalibration are some of the common traits describing unethical and ineffective leadership.[415] Brennan and Conroy analysed a bank CEO's letters to shareholders included in annual reports, finding evidence of narcissistic and hubris symptoms from a clinical perspective.[416] Other studies proved that a substantial percentage of corporate executives present psychopathic traits, which are commonly perceived as associated with 'good communication skills, strategic thinking, and creative/innovative ability'.[417] To give an idea of CEOs' overconfidence, an unnamed executive of Anglo-Irish Bank, one of the first casualties in the banking

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[411] Edwin H Sutherland, 'White-Collar Criminality', American Sociological Review (1940), 5, 1–12.
[412] Edwin H Sutherland, 'Hits Criminality in White Collars', *New York Times*, December 28, 1939; see also S R Donziger, *The real war on crime: The report of the National Criminal justice Commission*, Harper Perennial, 1996.
[413] Guy Rolnik, 'What Differentiates White-Collar Criminals From Other Executives? A Q&A With Eugene Soltes', Promarket.org, 19 October 2016.
[414] See de Haan & Jansen, n 392.
[415] ibid, 6–8.
[416] Niamh M Brennan and John P Conroy, 'Executive Hubris: The Case of a Bank CEO', Accounting, Auditing & Accountability Journal (2013), 26, 172–95.
[417] Paul Babiak, Craig S Neumann, and Robert D Hare, 'Corporate Psychopathy: Talking the Walk' Behavioural Sciences and the Law (2010), 28, 174–93.

crisis, was quoted as saying that the bank CEO, Sean Fitzpatrick, 'began to think he could walk on water'.[418] Similarly it was reported that Goldman Sachs' Chief Executive, Lloyd Blankfein, while defending bankers' high compensation, stated he was just 'doing God's work'.[419]

### 2.2.6 The ethical leader

Given that leaders might compromise a firm's future performance and reputation, as they influence workers' behaviour, they should first be looked at for establishing an ethical corporate culture.[420] William Dudley similarly noted that "the problems originate from the culture of firms, and this culture is largely shaped by the firms' leadership",[421] so that solutions "need to originate from within the firms, from their leaders". This topic has been developed by the literature on transformational leadership, which was defined as the process in which "leaders and followers help each other to advance to a higher level of morale and motivation".[422]

Other leadership theories have followed a different path,[423] such as transactional leadership, which is a performance-based system where employees are rewarded for reaching performance objectives agreed through contracts, without a long-term vision or high social purpose.[424] This type of approach, focusing on the

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[418] Shane Ross, *The Bankers: How the Banks Brought Ireland to its Knees*, Penguin, 2010.
[419] Matt Phillips, 'Goldman Sachs' Blankfein on Banking: "Doing God's Work"', *Wall Street Journal*, 9 November 2009 https://blogs.wsj.com/marketbeat/2009/11/09/goldman-sachs-blankfein-on-banking-doing-gods-work/ accessed 30 Octboer 2018.
[420] Ronald R Sims, 'The Challenge of Ethical Behaviour in Organizations', Journal of Business Ethics (1992), 11, 505–13; Lynn Sharp Paine, *Cases in Leadership, Ethics, and Organizational Integrity: A Strategic Perspective*, Irwin, 1997; and W Edward Stead, Dan L Worrell, and Jean Garner Stead, 'An Integrative Model For Understanding and Managing Ethical Behaviour in Business Organizations', Journal of Business Ethics (1990), 9, 233–42.
[421] Dudley, n 243.
[422] James MacGregor Burns, *Leadership*, Harper and Row, 1997, 20.
[423] Among these are, the Great Man theory, Trait theory, Contingency theory, Situational Leadership, Behavioural theories, and Transactional theory. For a review on leadership theories and styles, see Rose Ngozi Amanchukwu et al, 'A Review of Leadership Theories, Principles and Styles and their Relevance to Educational Management', Management (2005), 5, 1, 6–14; and Richard Bolden et al, 'A Review Leadership Theory and Competency Frameworks', Centre for Leadership Studies, (2003). For a comparison between transactional and transformational leadership theories, see Bernard M Bass, 'From Transactional to Transformational Leadership: Learning to Share the Vision', Organizational Dynamics (1990), 18, 3, 19–31. For a critical response, see Colin W Evers and Gabriele Lakomski, *Exploring educational administration: Choherentist applications and critical debates*, Elsevier Science, 1996; and Gary Yukl, 'An Evaluation of Conceptual Weaknesses in Transformational and Charismatic Leadership Theories', Leadership Quarterly (1999), 10, 2, 285–305.
[424] Bernard M Bass and Bruce J Avolio, *Improving organizational effectiveness through transformational leadership*, Sage, 1994.

fulfilment of performance goals in view of the organization members' and leaders' selfish needs, has dominated the financial industry over the last decades. In contrast, transformational leadership would require leaders and employees to set aside their self-interests and move 'toward higher and more universal needs and purposes',[425] to a sense of mission, by means of charisma, inspirational motivation, intellectual stimulation, and individualized consideration.[426] CEO's ability to intellectually stimulate the firm's employees, inducing them to question old assumptions and beliefs so as to deal with new contingencies in an innovative way,[427] seems to determine the firm's propensity to engage in corporate social responsibilities (CSR).

The notion of 'ethical leader' combines transformational leadership with engagement in CSR issues. Reference is made to the honest, trustworthy decision maker, who behaves ethically in her personal and professional life, by frequently communicating values to followers, setting clear ethical standards, role modelling, and using the reward system linked to those standards.[428] Grojean et al identify several ways leaders may transmit ethical values to members of an organization.[429] They pay special attention to the establishment of a clear vision through codes of conduct enforced by training courses and coaching.

Another famous distinction between management styles was developed by McGregor, who labelled two kinds of leadership styles as Theory X and Theory Y.[430] Leaders following Theory X structure their organization on the assumption that workers dislike their work, are lazy, and can only be motivated by money. Under this pessimistic view, leaders set up strict rules and controls, performance appraisals, and 'carrot and stick' schemes. On the contrary, those following Theory Y believe that their employees like their job, are moved by purpose, are happy to take initiatives, and can be self-motivated by their own passion. This optimistic view assumes a strong relationship of trust, which leads to a collaborative, innovative,

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[425] Lee G Bolman and Terry Deal, *Reframing Organizations. Artistry, Choice and Leadership*, Jossey Bass, 1997, 2nd ed, 314.
[426] Bass, n 423, 19–31.
[427] See Bernard M Bass, 'Does the Transactional-Transformational Leadership Paradigm Transcend Organizational and National Boundaries?', American Psychologist (1997), 52, 130–39.
[428] Michael E Brown and Linda K Trevino, 'Ethical Leadership: A Review and Future Directions', The Leadership Quarterly (2006), 17, 595–616.
[429] See Grojean et al, n 270, 223–41. They make reference to the following ways of transmitting ethical values: (i) use values-based leadership; (ii) set the example; (iii) establish clear expectations of ethical conduct; (iv) provide feedback, coaching, and support organizational values; (v) recognize and reward behaviours that support organizational values; (vi) be aware of individual differences among subordinates; (vii) establish leader training and mentoring.
[430] Douglas McGregor, *The Human Side of Enterprise*, McGraw-Hill, 1960, 45–77.

and happier workplace. According to McGregor's view, workers will adapt their values and behaviour to the expectations set by the leaders. Fear will lead to fear, whereas trust will develop a trustworthy workforce.

In the case of financial institutions, therefore, executives should first set a higher purpose transcending financial results, such as serving customers, employees, or society's interests.[431] Second, they should get to know their institution by conducting a cultural diagnostic survey[432] to identify culture groups within it.[433] Third, they should better communicate with lower levels, so as to prevent the establishment of subcultures conflicting with the main culture.[434] In the London Interbank Offered Rate (LIBOR) and Foreign Exchange (FOREX) manipulation scandals, for instance, unlawful practices spread out across banks horizontally through strong traders' networks with no control by senior management.[435] Fourth, caution has been suggested before finalizing a merger, since the compatibility between firms' cultures should be tested in advance.[436] Of course, the adoption of a leadership style and strategy should take into account the dimension and business model of the financial institution, as well as the national culture in which it operates.

To conclude this brief review on leadership, neuroscientific studies analysed brain processes influencing moral judgement[437] and offered tools which in theory could be used to assess the leaders' profiles—other than through traditional surveys and interviews conducted by financial supervisors such as the ECB — and to

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[431] Thakor, n 240.
[432] *Ibid.*
[433] Alan D Morrison and Joel D Shapiro, 'Governance and Culture in the Banking Sector', 2016, available at https://ssrn.com/abstract=2731357, accessed 20 November 2018.
[434] In this regard, Mulasem talked about the presence of 'silos' and 'tribes'. See Remarks by Mr Alberto G Musalem, Executive Vice President of the Integrated Policy Analysis Group of the Federal Reserve Bank of New York, at the Institute of Law and Finance conference 'Towards a New Age of Responsibility in Banking and Finance: Getting the Culture and the Ethics Right', Goethe-University, Frankfurt am Main, 23 November 2015.
[435] *Ibid.*
[436] Thakor, n 240.
[437] *See,* e.g., Matthew D Lieberman, 'Social Cognitive Neuroscience: A Review of Core Processes', Annual Review of Psychology (2007), 58, 259–89; Joshua D Greene et al, 'An FMRI Investigation of Emotional Engagement in Moral Judgment', Science, (2001), 293, 2105–8; Hauke R Heekeren et al, 'An FMRI Study of Simple Ethical Decision-Making', Neuroreport (2003), 14, 1215–19; Jorge Moll et al, 'The Neural Correlates of Moral Sensitivity: A Functional Magnetic Resonance Imaging Investigation of Basic and Moral Emotions', Journal of Neuroscience (2002), 22, 2730–36; Christian Voegtlin and Ina Maria Kaufmann, 'Neuroscience Research and Ethical Leadership: Insights from an Advanced Neurological Micro Foundation', 2002, paper presented at the Society for Business Ethics Annual Meeting, Boston 2012.

enhance ethical leadership.[438] Just to mention a few, a high degree of frontal right hemisphere coherence — which is defined as the coordinated electrodes' activity in the right frontal region of the brain measured by means of quantitative electroencephalogram (qEEG) technique — has been found to be related to greater emotional balance and socialized vision of the future. Similarly, the analyses of chemicals in the brain may allow to develop new individual-specific leadership development programmes.[439] Coaching and training should therefore be promoted for developing ethical leadership skills.[440]

In the light of the considerations above, EBA and ESMA guidelines, as well as the ECB guide, should consider board candidates and key function holders' social and ethical profile. Competence, experience, independency of mind and good repute might reveal insufficient for the establishment of a sound culture, since concrete behaviour, moral and ethicality are traits involved in decision-making.

[438] David A Waldman, Pierre A Balthazard, and Suzanne J Peterson, 'The Neuroscience of Leadership: Can We Revolutionize the Way that Leaders are Identified and Developed?', Academy of Management Perspectives (2011), 25, 1, 60–74.
[439] *Id.*
[440] Voegtlin & Kaufmann, n 437.

# Chapter III

## Internal Controls

2.3.1 Introduction. – 2.3.2 Risk Management. – 2.3.2.1 International principles and EU regulatory framework. – 2.3.2.2 Risk Culture. – 2.3.3 Compliance function. – 2.3.3.1 International principles and EU Framework. – 2.3.3.2 The failure of compliance. – 2.3.3.3 The psychology of compliance: group dynamics. – 2.3.3.4 Codes of conduct and ethics.

### 2.3.1 Introduction

Financial authorities' formal interest towards the sound internal control system of banking institutions dates back to 1998, when the Bank of International Settlement (BIS) published a framework for internal control systems for banks, where it stated that:

> "A system of effective internal controls is a critical component of bank management and a foundation for the safe and sound operation of banking organisations. A system of strong internal controls can help to ensure that the goals and objectives of a banking organisation will be met, that the bank will achieve long-term profitability targets, and maintain reliable financial and managerial reporting. Such a system can also help to ensure that the bank will comply with laws and regulations as well as policies, plans, internal rules and procedures, and decrease the risk of unexpected losses or damage to the bank's reputation."[441]

Currently, the main responsibilities for the internal control system in a bank are distributed along the so-called "three lines of defence".[442] The first line is represented by the business line, that has "ownership" of risk, whereby it acknowledges and manages the risk that it incurs in conducting its activities taking into account the bank's risk appetite and its policies, procedures and controls.[443] The second line of defence includes: (a) the independent risk management function,

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[441] BCBS, Framework for Internal Control Systems in Banking Organizations, 1998.
[442] BCBS, n 72, §41-43.
[443] *Id.*, §92.

which is responsible for identifying, measuring, monitoring and reporting risk on an enterprise-wide basis; and (b) the compliance function, which should routinely monitor compliance with laws, corporate governance rules, regulations, codes and policies to which the bank is subject. The third line of defence consists of an independent and effective internal audit function, that should provide independent review and objective assurance on the quality and effectiveness of the bank's internal control system. The independency of the second and third lines of defence is highlighted also by the recommendations concerning compensation, as the BCBS requires that "for employees in control functions (eg risk, compliance and internal audit), remuneration should be determined independently of any business line overseen, and performance measures should be based principally on the achievement of their own objectives so as not to compromise their independence". [444]

Within this complex system, the board should ensure that three lines of defence are properly positioned, staffed and resourced and carry out their responsibilities independently, objectively and effectively. [445] The board should also regularly review key policies and controls with senior management and the heads of the risk management, compliance and internal audit functions, in order to identify and address significant risks and issues as well as determine areas that need improvement.

The EU formal adherence to the above described internal control framework is confirmed by both first level rules – specifically by CRD IV provisions –[446] and second level rules – by the EBA guidelines.[447]

In this chapter, I focus on the specific functions responsible for the second line of defence – namely risk management and compliance function – as by no means they are some of the most influential determinants of a bank overall organizational culture. In particular, following a brief overview of international and EU regulatory framework, I specifically address the role of a sound risk culture in a banks and investigate the main socio-psychological factors underlying the failure of compliance systems.

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[444] *Id.*, §147.
[445] *Id.*, §44.
[446] In particular, Recital 54 states that "[…] Member States should introduce principles and standards to ensure effective oversight by the management body, promote a sound risk culture at all levels of credit institutions and investment firms and enable competent authorities to monitor the adequacy of internal governance arrangements". *See* also CRD IV, Article 74.
[447] *See* EBA, n 137, 10-11.

### 2.3.2 Risk Management

Financial institutions, for their own nature, have to deal with many risks,[448] that should be properly managed by means of a risk governance framework. Even if it is still not clear whether corporate governance was a key factor for the outburst of the financial crisis, it is clear that many members of the managing bodies of the banks involved were not even aware of what management was doing. An improper internal control system and, in particular, an inadequate risk management function, can therefore be said to have been a common trait in the banks involved in the scandals.[449]

Interestingly, a research conducted by Ellul and Yerramilli in 2012 found that – in a set of 74 large U.S. bank holding companies – those with strong and independent risk management function had lower enterprise-wide risk both before and during the crisis.[450] In particular, the authors, by collecting data from 1995 to 2010, created a Risk Management Index to measure the levels of strength and independence of risk management function. The results found that banks with higher levels of RMI in 2006 performed better during the crisis, as they: (i) had lower exposure to private-label mortgage-backed securities and trading assets, (ii) were less active in trading off-balance sheet derivative securities, (iii) had a smaller fraction of non-performing loans, and (iv) had lower downside risk. More recently,

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[448] Carey and Stulz distinguish among six types of risks: (i) market risk, associated with fluctuations in prices of traded financial instruments; (ii) credit risk, that is the risks that the obligor of a financial instrument held by a financial institution will fail to fulfil its obligation; (iii) operational risk, that is 'the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events' (as defined by the BCBS); (iv) liquidity risk, that can take the form of a market liquidity risk (i.e. the risk that a bank is unable to transact in a financial instrument at a price near its market value) and funding liquidity risk (i.e. the risk that a company or bank may be unable to meet short term financial demands); (v) strategic risk, that is the risk that a bank suffer an operating income shortfall due to a decrease in revenues which cannot be compensated by cost reduction; and (vi) business risk, associated to the bank's ability to generate sufficient revenue to cover its operational expenses. In addition to these risks, we can mention also reputational risks, systemic risks and legal risks. More recently, financial authorities started taking into consideration also the so-called 'conduct risk', *see* Antonella Sciarrone Alibrandi and Claudio Frigeni, 'Managing Conduct Risk: From Rules to Culture', in in D. Busch, G. Ferrarini and G. van Solinge (eds), *Governance of Financial Institutions*, (Oxford University Press, 2019), *Forthcoming*. See Mark Carey, Rene M. Stulz, 'The Risks of Financial Institutions', NBER Working Paper No. 11442/2005, and BCBS, Operational Risk – Supervisory Guidelines for the Advanced Measurement Approaches, June 2011.

[449] *See*, among others, Federal Reserve Senior Supervisors Group, 'Observations on Risk Management Practices during the Recent Market Turbulence', 2008; BCBS, n 105. At the EU level, see EU Commission, Green Paper Corporate Governance in financial institutions and remuneration policies, 2010; ESMA and EBA, n 100; CRD IV, Recital 53. In literature, *see*, among other, Hopt, n 25, 49 and 50.

[450] Andrew Ellul & Vijay Yerramilli, 'Stronger Risk Controls, Lower Risk: Evidence from U.S. Bank Holding Companies', The Journal of Finance (2013), 5, 1757-1803.

an empirical study performed on 81 EU banks showed a link between a sound risk culture and better stress indicators (derived from the 2014 ECB stress test), with particular reference to capital adequacy and risk exposure.[451]

Based on these results, financial regulators and supervisors widely supported – and intervened accordingly to – the view that strengthening risk management function requirements would play an important role in lowering enterprise-wide risk at banking institutions, with a particular focus on systemic risk prevention.[452] However, it should be recalled that risks are not bad risks per definition, and therefore risk management function does not have the only task of reducing risk-taking, as "taking actions that reduce risk can be costly for shareholders when lower risk means avoiding valuable investments and activities that have higher risk".[453] The main function of risk management, on the contrary, is to properly identify and measure the risks the bank is taking, avoid and eliminate bad risks but also ensure a risk level aligned with the risk appetite of the bank. The establishment of a well-functioning risk management system is therefore a complex task, as it requires a certain level of flexibility that can be satisfied with the imposition of strict rules, but with softer solutions, such as appropriate incentives and a sound risk culture[454].

#### 2.3.2.1 International principles and EU regulatory framework

In 2013, the FSB issued a thematic review in which it recognized the improvement made by national authorities in the regulatory and supervisory oversight of risk governance at financial institutions after the crisis. However, in order to ensure the continuous improvement of risk governance practices and avoid progress made to be fruitless, the FSB recommended further strengthening of risk management function.[455]

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[451] Sebastian Fritz-Morgenthal, Julia Hellmuth & Natalie Packham, 'Does Risk Culture Matter? The Relationship Between Risk Culture Indicators and Stress Test Results', Journal of Risk Management in Financial Institutions (2016*)*, 9, 71–84.
[452] 'Systemic risk' was defined as the risk that a trigger event (e.g. an economic shock or institutional failure), causes a chain of bad economic consequences 'domino effect'. *See* Schwarcz, n 35.
[453] *See* Rene M Stulz, 'Governance, Risk Management, and Risk-Taking in Banks', European Corporate Governance Institute (ECGI) - Finance Working Paper No. 427/2014, available at https://ssrn.com/abstract=2457947, accessed 21 November 2018.
[454] *Id.*
[455] FSB, 338, 4 et seq. The recommendations concerned, among other things: (i) the improvement of communication procedures between the risk committee and the board and across other board

Based on the FSB thematic review, the BCBS focused most of its attention on risk governance provisions in the design of its guidelines. In particular, the strengthening of board's responsibility for the oversight and risk governance of the bank was one of the primary objectives of the revision of the guidelines.[456] Moreover, the BCBS clarified and emphasized key concepts such as risk culture, risk appetite[457] and their relationship to a bank's risk capacity.[458] Accordingly, the new guidelines establish that it is the board's main task to establish, along with senior management and the Chief Risk Officer (CRO), the bank risk appetite, oversee the respect of the Risk Appetite Statement (RAS),[459] of risk policy and risk limits.

At the EU level, the CRD IV devotes a high number of provisions to the internal risk governance of institutions, and – in consistency with BCBS Principles – it emphasizes the key role played by the board. Pursuant to Article 76(1), the board has to approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks the bank might be exposed to. As already highlighted (see 1.2.3.2.1), the main novelty introduced by the directive is the requirement for the establishment of a risk committee in significant banks. Moreover, institutions have to established a 'risk management function' independent from the operational functions and that should ensure that all material risks are identified, measured and properly reported, and that should be lead by a dedicated senior manager or another senior person, removable only with the prior approval of the board.[460]

The EU approach is consistent with Ellul and Yerramilli findings, but also with the outcomes of other studies conducted on risk governance,[461] especially in relation to board functioning and CRO status. For instance, Lingel and Sheed, using

committees; (ii) the independence and competence requirements of board members; (iii) facilitating CRO involvement in bank activities and decisions, (iv) the annual performance of a independent assessment on the design and effectiveness of the risk governance framework.

[456] BCBS, n 72, 4. *See* also BCBS, 'Principles for the Sound Management of Operational Risk' (2013).

[457] The risk appetite is "the aggregate level and types of risk a bank is willing to assume, decided in advance and within its risk capacity, to achieve its strategic objectives and business plan". *See* BCBS, n 72, Glossary; and FSB, n 101.

[458] This is the "maximum amount of risk a bank is able to assume given its capital base, risk management and control capabilities as well as its regulatory constraints. *See* BCBS, n 72, Glossary.

[459] The RAS is defined as "the written articulation of the aggregate level and types of risk that a bank will accept, or avoid, in order to achieve its business objectives. It includes quantitative measures expressed relative to earnings, capital, risk measures, liquidity and other relevant measures as appropriate. It should also include qualitative statements to address reputation and conduct risks as well as money laundering and unethical practices". *See* BCBS, n 72, Glossary; and FSB, n 101.

[460] *Id.*, Article 76(5).

[461] *See*, for example, Mehran, Morrison and Shapiro, n 300, 12. In particular, the authors stressed the importance of risk management function.

a sample of the largest listed banks from 2004 to 2010, show that better board oversight by the risk committee (i.e. the level of banking experience found on this committee and also the frequency of meetings) in a given year is associate with lower risk the following year. The same study reveals that banks with CROs of higher status – in relation to their role as top executives and their compensation - have less risks. However, the authors did not find evidence that good risk management had a good impact on bank performance during the crisis.[462] On the contrary, Aebi, Sabato, and Schmid show that banks where the CRO reported directly to the board performed significantly better during the financial crisis, while banks where the CRO reported to the CEO performed significantly worse then other banks in the analyzed sample (573 banks in total).[463]

#### 2.3.2.2 Risk Culture

The notion of 'risk culture' is crucial within the risk governance framework. The FSB defines it as the "bank's norms, attitudes, and behavior related to risk awareness, risk-taking and risk management and controls that shape decisions on risks".[464] The specific risk culture established in an institution not only influences the decision-making processes of management and board members, but also deeply shapes employees' day-to-day practices.

Given the complexity and the high number of variables of the phenomenon, financial supervision – rather than regulation – is entrusted with the proper addressing and monitoring of bank risk culture, ensuring that the board put in place a proper structure for the correct management of risks across all the business lines. Consistently, in 2014 the FSB issued a guidance addressed to financial supervisors for a proper interaction with financial institutions on risk culture, in order to monitor the state of progress in risk culture of supervised entities.[465] In particular, supervisors should assess how the board and senior management systematically assess the risk culture of the institution. To do so, the FSB recommends to

[462] Anna Lingel & Elizabeth Sheedy, 'The influence of risk governance on risk outcomes – international evidence', unpublished working paper (2012).
[463] Vincent, Aebi, Gabriele Sabato & Markus Schmid, 'Risk management, corporate governance, and bank performance in the financial crisis', Journal of Banking and Finance (2012), 36, 3213-3226.
[464] FSB, n 101.
[465] *Id.*

supervisory authorities to perform a large set of monitoring activities, based – but not limited to – the assessment of a series of indicators (see Table 1).

At the EU level, the EBA followed the FSB approach to the assessment of risk culture in its Guidelines on Internal Governance.[466] In particular, the EBA recommends to banks the development of a proper risk culture by means of several activities and tools, such as policies, communication and staff training.[467] In accordance with FSB guidance, the EBA identifies four main drivers of a strong risk culture[468] - tone from the top, accountability, effective communication and challenge, and incentives.

To summarize, after the financial crisis, the supervisory commitment to promote the resilience of the financial system translated into an increasingly active role in the monitoring or risk-taking behaviours. However, the task is by no means a massive challenge for financial authorities, and becomes even harder for the ECB,[469] since it must perform its supervisory powers on significant institutions across all member states (within the euro area). As an institution's risk culture is also determined by national culture,[470] this should be taken into consideration by the EU supervisor during the performance of its periodic assessment, a task that may reveal particularly challenging and subject to a significant margin for error. Moreover, supervisors need to develop broad-based experience and a set of appropriate skills to assess risk culture, as well as new management and organizational tools.[471]. We may stress that, currently, the culture of banking supervision is under evolution, and the main trends are:[472] (i) an orientation towards learning and knowledge sharing, (ii) better communication with other authorities, markets, institutions and individuals, (iii) increased attention to the selection, development and retention of human resources, (iv) excellence in research, and (v) establishment of shared vision of values, objectives, and organizational behaviour.

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[466] EBA, n 137.
[467] *Id*, §96.
[468] *Id*, §98.
[469] Risk culture features prominently in the ECB document 'SSM supervisory statement on governance and risk appetite', published in June 2016, that states that expectations are that a strong risk appetite framework will help build a sound risk culture.
[470] Marco Di Antonio, 'Risk Culture in Different Bank Businesses', in A. Carretta, Franco Fiordelisi, and Paola Schwizer (eds), *Risk Culture in Banking*, Palgrave Macmillan, 2017, 42.
[471] Alessandro Carretta and Paola. Schwizer, 'Risk Culture in the Regulation and Supervision Framework', in A. Carretta, Franco Fiordelisi, and Paola Schwizer (eds), *Risk Culture in Banking*, Palgrave Macmillan, 2017, 73 *et seq.* See also Section 2.5.3.
[472] *Ibid.*

Table 1: FSB Risk Culture Indicators (2014)

| Main determinant | Indicator | |
|---|---|---|
| Tone from the top | Leading by example | • The board and senior management have a clear view of the risk culture to which they aspire, systematically monitor, assess and address weakness related to it.<br>• The board and senior management promote a risk culture that expects integrity and a sound approach to risk management.<br>• The board and senior management promote openness to challenge within the board.<br>• The board and senior management are committed to establishing, monitoring, and adhering to an effective risk appetite framework, supported by appropriate risk appetite statement.<br>• Mechanisms are in place to ensure decision-making is not dominated by any one individual or small group.<br>• Senior management is subject to the same expectations for integrity, risk governance, and risk culture as all other employees; that is, mechanisms are in place to subject senior management to incentive structures. |
| | Assessing espoused values | • The board and senior management systematically aff at all levels.<br>• The board and senior management assess whether the institution's risk appetite framework and business strategy are clearly understood and embedded in the decision-making and operations of the business. |
| | Ensuring common understanding and awareness of risk | • Appropriate mechanisms are in place to ensure the risk appetite, risk management strategy, and business strategy are effectively aligned and embedded in decision- making and operations.<br>• The board and senior management have clear views on the business lines considered to pose the greatest challenges in the management of risk.<br>• The board and senior management systematically monitor how promptly and effectively issues raised by the board, supervisors, and all control functions are addressed by management. |
| | Learning from past experiences | • Processes are in place to review deficiencies in risk management are reviewed.<br>• Assessment and communication of lessons learnt from past events are seen as an opportunity to enhance the institution's risk culture, and to enact real changes for the future. |

| | | |
|---|---|---|
| Accountability | Ownership of risks | • Clear expectations are set with respect to the monitoring and reporting of, and response to, current and emerging risk information across the institution.<br>• Mechanisms are in place for the sharing of information on emerging, as well as low probability, high impact risks, both horizontally across business lines and vertically up the institution.<br>• The CEO, senior management and employees are held accountable for their actions and understand the consequences if they are not aligned with the institution's core values, risk appetite and risk culture. |
| | Escalation process | • Appropriate escalation processes are established to support risk management and clear consequences for non-compliance with escalation procedures are defined. Systematic assessments are conducted on whether employees are aware of escalation processes and believe the environment is open to critical challenge.<br>• Mechanisms are established for employees to elevate and report concerns when they feel discomfort about products or practices, even where they are not making a specific allegation of wrongdoing.<br>• Appropriate whistleblowing procedures are in place. |
| | Clear consequences | • Consequences are clearly established, articulated and applied for anyone engaged in, or supporting, risk-taking that is excessive relative to the financial institution's risk appetite statement.<br>• Breaches in internal policies, procedures and risk limits, and internal codes of conduct, are understood to have a potential impact on an individual's compensation, responsibilities, career progression and termination. |
| Effective communication and challenge | Open to alternate views | • Alternate views or questions from individuals and groups are encouraged and valued.<br>• Mechanisms are in place so that alternate views can be expressed in practice. |
| | Stature of control functions | • Control functions (e.g. risk management, internal audit, compliance) share the same stature as the business lines, actively participate in committees and are proactively involved in all relevant risk decisions and activities.<br>• Control functions operate independently, have appropriate direct access to the board and |

| | | |
|---|---|---|
| | | senior management and a process is in place for them to periodically report to the board.<br>• Control functions, including their respective representatives, have sufficient stature not only to act as advisors, but to effectively exert control tasks with respect to the institution´s risk culture. |
| Incentives | Remuneration and performance | • The compensation structure supports the institution’s espoused core values and promotes sound risk-taking behaviour and is supported by a well-documented process.<br>• Remuneration and performance metrics consistently support and drive the desired risk- taking behaviours, risk appetite and risk culture of the financial institution.<br>• Annual performance reviews and objectives-setting processes are linked to promoting the institution’s desired core values and behaviours as well as compliance with policies and procedures, including addressing in a timely manner deficiencies highlighted by internal audit and supervisory findings.<br>• Incentive compensation programs systematically include individual and group adherence to the financial institution’s core values and risk culture. |
| | Succession planning | • Succession planning processes for key management positions include risk management experience. |
| | Talent development | • Understanding key risks, essential elements of risk management, and the institution’s culture<br>• Job rotation between control functions and business lines.<br>• Training programs are available for all staff to develop risk management competencies. |

However, notwithstanding financial institutions' new attention to risk culture factor – as well as the advanced debate among practitioners –[473] the academic literature addressed the issue with a certain delay, maybe due to the need of an interdisciplinary approach to it,[474] but also to the difficulties found in measuring it.[475] In particular, some authors highlighted how risk culture communication can be misleading, due to the opposition between 'espoused values' – values included in bank statements and codes of ethics or codes od conduct – and real practices - what bank staff actually do, based on values and behaviours really rooted in the institution.[476]

Only recently some scholars started to specifically study risk culture in financial institutions. Power et al., for instance, found some common patterns among the vast number of risk-cultural approaches.[477] At a high level, they distinguish between 'organic approaches' to risk culture and 'engineered programmes', where the former category is based on a confident informal approach to change risk culture in the organization over long timescales with emphasis on ethics and mission, while the latter is advisor and regulator-driven, based on metrics and performance incentives and tend to favour shorter timeframes for change. Below this level, firms have to deal with numerous tensions and trade-offs that cannot be fully categorized.[478]

As for the main determinants of different risk cultures, Di Antonio[479] identified both structural/endogenous factors, and contingent/external factors. The first category includes: (i) the activities performed and their embedded risks, (ii) the nature and role of customers, and (iii) the economics of business. The contingent risks include several factors, such as market competitiveness,

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[473] *See*, for a review, Michael Power, Simon Ashby & Tommaso Palermo, 'Risk Culture in Financial Organizations: A Research Report', London School of Economics (2013).

[474] *See* Alessandro Carretta, Franco Fiordelisi, and Paola Schwizer (eds), *Risk Culture in Banking*, Palgrave Macmillan, London, 2017, 2.

[475] *See* Stulz, n 453.

[476] Di Antonio, n 470, 38.

[477] Power, Simon & Palermo, n 473.

[478] However, the authors identify some visible trade-offs, based on the balancing of: (i) the commercial and regulatory authority of the risk function, (ii) the use of formal organisational arrangements with interactive approaches to risk management, (iii) risk support for disciplined business decisions against the risks of imposing excessive controls, (iv) the use of advisors with 'going it alone', (v) regulator and regulated culture, and (vi) ethics and incentives as levers over behavioural change.

[479] Di Antonio, n 470, 40 ss.

regulation, history and evolution of the business, size and diversification of the financial institution, ownership model, national culture, strategic orientation, organisational systems and practices, and employees' individual culture.

In light of all the considerations above, it should be definitely confirmed the inadequacy of regulators' intervention on the field of banks' risk culture governance, and again the essential role of boards and supervisors financial supervision in managing this dynamic and constantly changing framework.

### 2.3.3 Compliance function

Together with risk management, compliance function forms the "second line of defence" within the internal control system.

The importance of compliance have greatly expanded in the last years, mainly for the increase in complexity of financial products and in the diversification of risks incurred by institutions. Especially in the EU, banks are now required to perform a very high degree of vigilance on the concrete respect of rules, a task that is becoming progressively difficult, considered the still evolving flow of new financial regulation.

However, compliance is by no means also an expression of the culture of the bank, as it is associated with the way board members, managerial staff and employees within the institution perceive and value the respect of rules, standards and practices. And if financial regulators have for years approached compliance with a 'detect-and-punish' method, behavioral studies show that rule-breaking can be avoided also by changing the 'choice architecture' of compliance decisions.[480] Only by understanding which contextual factors can induce people to break rule, regulators and banks can successfully play their key role in the promotion of a sound culture of compliance, where moral values are deeply integrated in conduct and behavior of individuals at all levels.

[480] FCA, 'Behaviour and Compliance in Organisations', Occasional Paper 24/2016 https://www.fca.org.uk/publication/occasional-papers/op16-24.pdf, accessed 20 November 2018.

#### 2.3.3.1 International principles and EU Framework

At the international level, the BCBS provided basic standards and principles for compliance function in the 2005 guidance "Compliance and the compliance function in banks'.[481] In particular, the BCBS defines the notion of "compliance risk" as "the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities".[482] The guidance also specifies that "compliance starts at the top" and "it will be most effective in a corporate culture that emphasises standards of honesty and integrity and in which the board of directors and senior management lead by example".[483] In particular, the senior management is responsible for establishing and communicating the bank's compliance policy, as well as for reporting to the board of directors on the management of the bank's compliance risk and establishing a permanent and effective compliance function,[484] while the board of directors should approve it and ensure its proper implementation.[485]

The compliance function should assist senior managers by offering its advice, providing guidance and education to the staff, identifying, measuring and assessing compliance risks associated with the bank's business activities, and monitoring, testing and reporting on compliance.[486] The independence of the compliance function should be properly ensured, and possible conflicts of interests should be avoided.[487] Moreover, to be effective, the compliance function must have sufficient authority, stature, independence, resources and access to the board.[488] To this end, an executive or senior staff member – usually called 'head

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[481] BCBS, 'Compliance and the compliance function in banks', April 2005.
[482] *Id.*, § 3.
[483] *Id.*, § 2.
[484] *Id.*, §15-19.
[485] *Id.*, § 14.
[486] *Id.*, § 35-41.
[487] *Id.*, § 20.
[488] *Id.*, § 22.

of compliance' – should be nominated, with the overall responsibility for coordinating compliance-related activities.[489]

The same compliance principles have been included in the BCBS Corporate Governance Principles for Banks.[490] Interestingly, these guidelines even suggest that an ethics and compliance committee should be established within the board.[491]

At the EU level, the discipline concerning compliance function, which is aligned with international standards, is provided in the EBA guidelines on internal governance. Some references are made in the CRD IV, that specifies that the management body is responsible for the integrity of compliance systems,[492] and that the remuneration committee or the board in its supervisory function should directly oversee the compensation of senior officers in the compliance function.[493]

However, a thorough study of compliance cannot overlook the analysis of rule-breaking phenomena, that requires to focus on certain underlying psychological group dynamics.

#### 2.3.3.2 The failure of compliance

As Baxter correctly said in relation to compliance, "if organizational values do not support the rules that organizations use to guide the behavior of employees, and worse, if organizational values actually conflict with those rules, the organization is headed for troubled territory".[494] Thus, ensuring compliance to rules became the core task of compliance function in banks. However, a real change cannot be realized until we move from a model of compliance to rules to system of compliance to values, values that should necessarily be aligned with the rules, standards and practices established and implemented in the bank.

[489] *Id.*, § 22.
[490] BCBS, n 72 Principle 9.
[491] *Id.*, § 77.
[492] CRD IV, Article 88(1)(b).
[493] CRD IV, Article 92(2)(f).
[494] *See* Baxter, n 231.

Moreover, it should be always kept in mind that compliance involves a large set of organizational aspects – such as leadership, incentives, governance, controls –, that it interests, in particular, the entire human resource management function – from the hiring process, to training and compensation -, and should be consistent at each level of the organization, starting from the top.

In other words, monitoring-based systems – which usually have high costs – should be replaced by an integrity-based system based on persuasion instead of commandment, so that "an ethical framework becomes no longer a burdensome constraint within which companies must operate, but the governing ethos of an organization".[495] Moreover, designing compliance-based system only based on legal violations detection and punishment is not enough to create a culture that encourages organization ethicality and to identify and address underlying altered cognitive processes. In fact, many behavioral biases may affect individual ability to meet compliance goals, by altering their preferences, beliefs and decision-making. An FCA occasional paper[496] identified seven behavioral biases – namely 'present bias',[497] 'endowment effects and loss aversion',[498] 'omission bias',[499] 'overconfidence',[500] 'confirmation bias',[501] 'salience and vividness',[502] and 'groupthink'[503] - able to increase the likelihood of rule breaking. This suggests that a holistic approach – instead of a narrow legalistic approach -[504] is the only

[495] Lynne Paine, 'Managing for Organizational Integrity', Harvard Business Review (March-April 1994), 106.
[496] FCA, n 480.
[497] Individuals generally prefer to obtain something now rather than later. Therefore, short-term gain may seem preferable than long-term reward, and more immediate and concrete than a possible future punishment.
[498] Individuals tend to value something they have more than something they have not, and consequently are excessively attached to existing compliance processes.
[499] Omission is usually preferred to action. For this reason, the likelihood of people breaching a rule that prohibits an act is lower than the likelihood they fail to comply to a required behaviour.
[500] Overconfidence leads individual to have excessive faith in their own abilities, making them believe that the likelihood of being punished is low, while the likelihood of succeed is particularly high.
[501] People tend to seek evidence that support their beliefs and ignore evidence proving the contrary.
[502] Judgements are mostly based on salient and vivid available information, not on all information. The way rule breaches punishment are communicated may lead individual to focus more on some rules than others, at the expenses of other provisions.
[503] As I analyse in the next Section, people tend to act in a different way in group-context.
[504] Linda Klebe Trevino et al., 'Managing Ethics and Legal Compliance: What Works and What Hurts', Cal. Mgt. Rev. (Winter 1999), 41,131.

reasonable approach to face this complex reality, and this should vary depending on the specific institution and context analyzed.

In the next sections, I specifically analyse two aspects of compliance failure – collective psychological pressures and ineffective design and implementation of codes of conducts - and provide suggestions to build a better choice architecture to promote better decision-making.

#### 2.3.3.3 The psychology of compliance: group dynamics

Specific group pressures may alter individuals' tendency to comply to rules, norms, standards and codes of conduct. However, in order to better understand how these pressures affect behaviour, some misconceptions should be first handled.

It is a common belief that only immoral individuals, the so-called 'bad apples', commit serious misbehaviour. Nevertheless, it is well established that corporate crimes often involve people within an organization who are not 'bad apples', but 'ordinary men and women'.[505] Indeed, when individuals act under a particular cognitive framing or in a group context their behaviour may deviate from the rational norm and their decision making and judgemental processes may be altered.[506] Many studies concern group behaviour both in social psychology[507] and behavioural economics.[508] Common results from these studies

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[505] Saul W Gellerman, 'Why "Good" Managers Make Bad Ethical Choices', Harvard Business Review (1986), 6, available at https://h br.org/1986/07/why-good-managers-make-bad-ethical-choices, accessed 21 November 2018.

[506] This is well explained in the contraposition between the expected-utility theory and the prospect theory, in Amos Tversky and Daniel Kahneman, 'Rational Choice and the Framing of Decision', The Journal of Business (1986), 59, 4, 251–78, and Daniel Kahneman and Amos Tversky, 'Prospect Theory: An Analysis of Decision under Risk', Econometrica (1979), 47, 2, 263–92.

[507] For a review *see*, *inter alia*, James H Davis, 'Some Compelling Intuitions about Group Consensus Decisions, Theoretical and Empirical Research, and Interpersonal Aggregation Phenomena: Selected Examples, 1950-1990', Organizational Behaviour and Human Decision Processes' (1992), 52, 3–38. A famous experiment on the effects of cognitive framing was conducted by Tversky and Kahneman; *see* Amos Tversky and Daniel Kahneman, 'The Framing of Decisions and the Psychology of Choice', Science (1981), 211, 453–58.

[508] For a review *see*, *inter alia*, Michael J O'Fallon and Kenneth D Butterfield, 'A Review of The Empirical Ethical Decision-Making Literature', Journal of Business Ethics (2005), 59, 375–413;

are that cognitive frames matter[509] and that decision makers do not always follow profit maximization as the main criterion for acting. Compliance and conformity might depend on authority and obedience, social norms, reciprocation, 'rejection-than-moderation' procedures,[510] all based on three main motivations: accuracy, affiliation, and the maintenance of a positive self-concept.[511] In a famous experiment, Asch proved that people's opinion usually changed if they were put under conformity pressure in a group context, even if following the majority trend meant giving clearly wrong answers during a test.[512] Another experiment by Milgram shed light on the dangerous implications of authority's pressure on ethical behaviour,[513] as later confirmed by a survey which found superiors' behaviour as the most influential factor leading to unethical actions.[514]

Moreover, the use of an aggressive corporate language,[515] such as one recalling war and fear in a Hobbesian way, is also common amongst unethical leaders, who have led unethical working teams. Deutsche Bank's senior manager Edson Mitchell and his team, for example, used to refer to themselves as 'mercenaries' and 'conquistadors'.[516] According to an experiment run by McNeil in 1982,[517] the way information is spread within an organization is likely to

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and Christopher Engel, 'The Behaviours of Corporate Actors: A Survey of the Empirical Literature' Journal of Institutional Economics (2010), 4, 445.

[509] A frame is defined as 'a stable, coherent cognitive structure that organizes and simplifies the complex reality that a manager operates in'; J Eward Russo and Paul J H Schoemaker, 'Managing Frames to Make Better Decisions', in Stephen J Hoch and Howard C Kunreuther (eds), *Wharton on Making Decisions*, Wiley, 2001, 131–55.

[510] This strategy, based on the norm of reciprocation, implies that one makes an excessive request (likely to be rejected), but later makes some concessions. Because of these concessions, 'the target feels a normative obligation to reciprocate the influence agent's concession with a concession of his or her own' and, as a consequence, he would probably accept to comply to the new request. See Robert B Cialdini and Noah J Goldstein, 'Social Influence: Compliance and Conformity', Annual Review of Psychology (2004), 55, 591–621.

[511] *Ibid.*

[512] Solomon E Asch, 'Opinions and social pressure', Scientific American (1955), 193, 31–355.

[513] Stanley Milgram, *Obedience to Authority: An Experimental View*, Harper and Row, 1974.

[514] Blake E Ashforth and Vikas Anand, 'The Normalization of Corruption in Organizations', Research in Organizational Behaviour (2003), 25, 1–52.

[515] Patelli & Pedrini, n 398, 3–19; Guido Palazzo, Franciska Krings, and Ulrich Hoffrage, 'Ethical Blindness' Journal of Business Ethics (2011), 109, 3, 323–38; Kevin Allen, 'How Language Shapes Your Organization', Harvard Business Review, 2012, available at https://hbr.org/2012/07/how-language-shapes-your-organization, accessed 5 November 2018.

[516] Fichtner, Goos & Hesse, n 403.

[517] Barbara J McNeil et al, 'On the elicitation of preferences for alternative therapies', New England Journal of Medicine (1982), 306, 1259–62.

influence its members' decision making under risk, especially when information is limited and members rely on a very limited number of biasing heuristics.[518]

However, risks arise both from inside and outside the organization. If a broad view of the current financial system is adopted, the institutional context is often characterized by a systemic moral disconnection of companies and their members from the societal context.[519] An organization may promote misbehaviour by encouraging values such as aggressiveness, competitiveness, and profit at all costs.[520] Specialization and a competence-based model of professional behaviour increase efficiency, but may reduce the agents' attention to other aspects and dimensions of decision making,[521] causing a sort of 'moral disengagement' from the real issues that they are dealing with.[522] In other words, common people who find themselves in strong unethical contexts, in 'bad larders',[523] sometimes commit crimes being unaware of the unethicality of their conduct. Some scholars talk about 'ethically blind' individuals,[524] as a result of group pressures. Ethical blindness is defined as the 'temporary inability of a decision maker to see the ethical dimension of a decision at stake'.[525] The individual hence deviates from her own values and beliefs as a result of some psychological processes that narrows its cognitive framing. However, this view could be a dangerous justification for misbehaviour. Strong contexts can no doubt facilitate the rise of a corrupt corporate culture and therefore influence members' behaviour, but it is difficult to believe that the relevant agents are entirely unaware of the immorality of their actions. We are rather confronted with an ethical rationalization[526] or a normalization of dishonest behaviour,[527] as

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[518] See Amos Tversky and Daniel Kahneman, 'Judgement under Uncertainty: Heuristics and Biases', Science (1974), 185, 1124–31.
[519] Michael Gonin, Guido Palazzo & Ulrich Hoffrage, 'Neither Bad Apple Nor Bad Barrel: How the Societal Context Impacts Unethical Behaviours in Organizations', Business Ethics: A European Review (2012), 21, 1, 31–46.
[520] Sims, n 420; Stead, Worrell & Stead, n 420, 233–42.
[521] Gonin, Palazzo, & Ulrich Hoffrage, n 519.
[522] Albert Bandura, 'Selective Moral Disengagement in the Exercise of Moral Agency', Journal of Moral Education (2002), 31, 2, 101–19.
[523] Gonin, Palazzo, & Hoffrage, n 519.
[524] Palazzo, Krings, & Hoffrage, n 515.
[525] ibid.
[526] John M Darley, 'How Organizations Socialize Individuals into Evildoing' in D Messick and A Tenbrunsel (eds), *Codes of Conduct: Behavioral Research into Business Ethics*, Russell Sage Foundation, 1996, 13–43.

described by Ashforth and Anand:[528] moral concerns are suppressed to prioritize other interests, which are more direct, urgent, or advantageous. 'Ethical short-sightedness', rather than 'ethical blindness' should be cautiously referred to.

It should also be considered that, notwithstanding the influence of organizational and situational factors, there is always space for individuality and virtues training when it comes to ethical decision making. Trevino and Youngblood found that individual differences as to locus of control determine variances in the probability for an individual to act unethically. Based on these findings, they conclude that selection and training are important for organizations that want to be ethical.[529]

To draw some preliminary conclusions, group pressures may induce individuals to put aside their moral concerns to benefit other priorities. However, priority rules are designed, sometimes unconsciously, by the way those in charge of the organization communicate and behave. To change the culture of compliance of the organization, collective pressures, far from being thoroughly repressed, should be reshaped by senior management and board members to address employees to virtuous behaviour. For instance, based on the need for acceptance in the group, individuals tend to attribute great value to the risk to be disapproved by their peers. As a result, if the probability of disapproval in case of rule-breaking is high, the likelihood of illicit conduct then automatically decreases. The correct enforcement of internal sanctioning measures is therefore by no means a key factor, as the way punishment and the underlying values it involves are perceived as just or unfair, may determine the collective way to deal with compliance. From regulators' and supervisor's perspective, communication should be focused on salient and vivid instances of detection and punishment, in order to change people's perception of the expected costs of wrongdoings.[530]

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[527] According to Ashforth and Anand, this normalization process consists of three main phases: institutionalization, rationalization, and socialization.
[528] Ashforth & Anand, n 200. See also Gellerman's model, which identifies four beliefs leading to unethical decisions: (i) the activity is is not 'really' illegal or immoral; (ii) the activity is in the company's best interest; (iii) the activity will never be found out; and (iv) the company will protect the person engaging in the activity, since he perform it in its interest: Gellerman, n 191.
[529] Linda Klebe Trevino and Stuart A Youngblood, 'Bad Apples in Bad Barrels: Causal Analysis of Ethical Decision-Making Behaviours', Journal of Applied Psychology (1990), 75, 4, 378–85.
[530] FCA, n 480.

However, the organizational values should be communicated also by means of other tools, such as incentives (see Chapter IV) and codes of conduct (see Section 2.3.3.4) .

2.3.3.4 Codes of conduct and ethics

(i) A Global Practice

Over the years, professional associations and individual firms (both financial and non-financial)[531] have drafted many 'codes of conduct', 'codes of ethics', 'statements of business principles', and 'charters'[532] modelling the organizational culture of corporations in order to prevent future misbehaviour. Most firms have been pressured to adopt codes of conduct by legislation, the media, their shareholders and/or stakeholders.[533] The Corporate governance principles for banks issued by the Basel Committee on Banking Supervision (BCBS) in 2015 exhort banks to adopt internal codes of conduct and practice guidelines.[534] At the EU level, the EBA recommend the board to "develop, adopt, adhere to and promote high ethical and professional standards, taking into account the specific needs and characteristics of the institution, and should ensure the implementation of such standards (through a code of conduct or similar instrument)".[535] The main purpose of the standards, according to the

[531] These include, for example: the Chartered Financial Analyst (CFA) Institute Code of Ethics and Standards of Professional Conduct; the Chartered Institute for Securities and Investment Code of Conduct; the Alternative Investment Management Association Guides to Sound Practices; the European Code of Good Conduct for Microcredit Provision; the United Nations Global Compact; the Organization for Economic Cooperation and Development Guidelines for Multinational Enterprises; and the International Organisation for Standardisation (ISO) environmental management system standards.
[532] For a brief review of the terms used to indicate this kind of codes and of how variations in the usage of the terms could lead to methodological deficiencies, *see* Muel Kaptein and Mark S Schwartz, 'The Effectiveness of Business Codes: A Critical Examination of Existing Studies and the Development of an Integrated Research Model', *Journal of Business Ethics* (2008), *77*, 111–27.
[533] *See* Sandra A Waddock, Charles Bodwell, and Samuel B Graves, 'Responsibility: The New Business Imperative', *Academy of Management Executive* (2002), *16*, 132–47; and Mark S Schwartz, 'Effective Corporate Codes of Ethics: Perceptions of Code Users' *Journal of Business Ethics* (2004), *55*, 323–43.
[534] BCBS, n 72, 30, 135.
[535] EBA, n 137, 99.

EBA, is the reduction of risk exposure, with special attention to operational and reputational risks.

To measure the level of diffusion of the codes of conduct worldwide, I analysed the data published by the thirty systemically important banks (G-SIBs) identified by the FSB on their websites and found (Table 2) that almost all banks based in Europe and the United States have adopted either a code of ethics or a code of conduct.[536] Asian banks, especially in China, are less compliant with this requirement. However, ethical issues and concerns are obviously not ignored by banks in these countries. The China Banking Regulatory Commission, in particular, issued a Guidance on Professional Conducts for Staff of Banking and Financial Institutions in 2009 and the Banking Sector Financial Institution Professional Conduct Administration Guideline in March 2018.[537] CSR and ethical issues are usually considered in Chinese banks' CSR reports.[538]

Table 2 G-SIBs: Codes of Conducts and Ethics

| **Bank** | **Country** | **Code of conduct or Code of Ethics** | **Waivers/ exceptions** |
|---|---|---|---|
| 1) Citigroup | US | Code of Conduct<br>Code of Ethics for financial Profession | Yes |
| 2) JP Morgan Chase | US | Code of Conduct<br>Code of Ethics | Yes |
| 3) Bank of America | US | Code of conduct<br>Code of Ethics | Yes |
| 4) BNP Paribas | France | Code of Conduct | No |
| 5) Deutsche Bank | Germany | Code of Business Conduct and Ethics | No |
| 6) HSBC | UK | Statement of Business Principles and Code of Ethics | No |
| 7) Barclays | UK | Code of Conduct | Yes |

[536] FSB, '2016 list of global systemically important banks (G-SIBs)', November 2016, available at http://www.fsb.org/2016/11/2016-list-of-global-systemically-important-banks-g-sibs/, accessed 10 September 2018.
[537] William Blair, 'Reconceptualising the role of standards in supporting financial regulation', in Ross P Buckley, Emilios Avgouleas, and Douglas W Arner (eds), *Reconceptualising Global Finance and its Regulation*, Cambridge University Press, 2016, 419–41.
[538] Jingchen Zhao, *Corporate Social Responsibility in Contemporary China*, Elgar, 2014, 192 *et seq.*

| | | Code of Ethics | |
|---|---|---|---|
| 8) Credit Suisse | Switzerland | Code of Conduct | No |
| 9) Goldman Sachs | US | Code of Business Conduct and Ethics | Yes |
| 10) Industrial and Commercial Bank of China Limited | China | Annual CSR Report (the issuance of a Code of Ethics is mentioned in a 2012 Statement) | N/A |
| 11) Mitsubishi UFJ FG | Japan | Principles of Ethics and Conduct | No |
| 12) Wells Fargo | US | Code of Ethics & Business Conduct | Yes |
| 13) Agricultural Bank of China | China | 2017 Annual CSR Report | N/A |
| 14) Bank of China | China | 2017 Annual CSR Report | N/A |
| 15) Bank of New York Mellon | US | Employee Code of Conduct | Yes |
| 16) China Construction Bank | China | 2017 Annual CSR Report | N/A |
| 17) Groupe BPCE | France | "Being responsible" Annual Report | N/A |
| 18) Groupe Crédit Agricole | France | Code of Ethics | No |
| 19) ING Bank | Netherlands | Ethical Principles | No |
| 20) Mizuho FG | Japan | Code of Conduct | No |
| 21) Morgan Stanley | US | Code of Ethics and Business Conduct | Yes |
| 21) Nordea | Baltic States | Code of Conduct | No |
| 23) Royal Bank of Scotland | UK | Code of Conduct | No |
| 24) Santander | Spain | General Code of Conduct | No |
| 25) Société Générale | France | Group Code of Conduct | No |
| 26) Standard Chartered | UK | Code of Conduct | No |
| 27) State Street | US | Code of conduct for employees<br>Code of conduct for directors<br>Code of Ethics for Senior Financial Officers | Yes |
| 28) Sumitomo Mitsui FG | Japan | CSR Policy | No |
| 29) UBS | Switzerland | Code of Conduct and Ethics | No |
| 30) Unicredit Group | Italy | Code of Ethics<br>Code of Conduct<br>Integrity Charter | No |

The relevant codes are generally structured as written statements in which the bank expresses its culture and vision, specifies its main values, and prescribes the rules of conduct that top managers and employees have to comply with.[539] The adoption of these codes generally benefits the firm's reputation and image, since it communicates a focus on CSR issues to customers and other stakeholders.[540] Codes are also considered as tools able to make wrongdoings less frequent,[541] and reduce consumer claims and the need for government regulation,[542] in addition to providing guidance to decision makers facing a moral dilemma.[543]

There is also strong empirical evidence on the relationship between the quality of codes of conduct and CSR performance, measured on the basis of the presence of a company in CSR and ethical ranking systems (such as Dow Jones Sustainability Index, 100 Best Corporate Citizens, World's Most Respected Companies, and Covalence Ethical Rankings).[544] Companies listed in top CSR ranking systems were found to have 'significantly higher quality codes on average compared to the population of all companies'.[545] In the United States, a study reported that the adoption of codes of ethics pursuant to section 406 of the Sarbanes-Oxley Act, addressed to top financial and accounting officers of public

[539] Johan Graafland, Bert van de Ven, and Nelleke Stoffele, 'Strategies and Instruments for Organising CSR by Small and Large Businesses in the Netherlands', *Journal of Business Ethics* (2003), *47*, 45–51.
[540] *Ibid*, and Gary R Weaver et al, 'Integrated and Decoupled Corporate Social Performance: Management Commitments, External Pressures, and Corporate Ethics Practices', *Academy of Management Journal* (1999), *42*, 539–52.
[541] Mark John Somers, 'Ethical Codes of Conduct and Organizational Context: a Study of the Relationship between Codes of Conduct, Employee Behaviours and Organizational Values', *Journal of Business Ethics* (2001), *30*, 2, 185–95.
[542] Janelle Diller, 'A Social Conscience in the Global Marketplace? Labour Dimensions of Codes of Conduct, Social Labelling and Investor Initiative', *International Labour Organization* (1999), *138*, 2, 99–129; Harvey L Pitt and Karl A Groskaufmanis, 'Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct', *Georgetown Law Journal*, (1989–1990), *78*, 1559–654.
[543] John M Stevens et al, 'Symbolic or Substantive Document? The Influence of Ethics Codes on Financial Executives' Decisions', *Strategic Management Journal* (2005), *26*, 2, 181–95.
[544] Patrick M Erwin, 'Corporate Codes of Conduct: The Effects of Code Content and Quality on Ethical Performance' (2010) *Journal of Business Ethics 99*, 535–548.
[545] *Ibid.*

companies in their financial reporting activities, promoted the integrity of the financial services industry in terms of better scrutiny on financial reports.[546]

(ii) The limited effectiveness of codes of conduct

However, many scholars have criticized the effectiveness of codes of conduct. Blair et al[547] examined the Chartered Financial Analyst (CFA) Institute's Code of Ethics and Standards of Professional Conduct, arguing that information asymmetries and lack of credibility in the enforcement of disciplinary sanctions represent limitations to a meaningful influence of the code on members' behaviours. The effectiveness of reputational sanctions too seems to be low because of the lack of information within the marketplace. Empirical studies also show mixed results. Kaptein and Schwartz[548] found that out of seventy-nine empirical studies on the effectiveness of companies' codes, 35 per cent reported that they played a positive effect, 33 per cent found no significant effect, 16 per cent considered their effectiveness to be weak, 14 per cent reported mixed results and one study found codes of conduct to be counterproductive.

Several circumstances can explain this failure. Firstly, adopting a code of conduct is the norm today. As a result, adoption may become a mere formality, if not a 'greenwashing' practice intended to cover companies' less than ethical business.[549] Secondly, codes of conduct and ethics frequently contain waiver clauses formally in compliance with regulation. In the analysis of the documents published by the G-SIBs (Table 16.1), this was found to be a common practice for US banks.[550] However, waiver clauses in ethical codes are a questionable and

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[546] Saurabh Ahluwalia et al, 'Sarbanes–Oxley Section 406 Code of Ethics for Senior Financial Officers and Firm Behaviours', Journal of Business Ethics (2016), 1–13.
[547] Dan Awrey, William Blair, and David Kershaw, 'Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation?' LSE Legal Studies Working Paper No 14/2012. Available at https://ssrn.com/abstract=2157588, accessed 30 September 2018, or http://dx.doi.org/10.2139/ssrn.2157588, 30 September 2018.
[548] Kaptein & Schwartz, n 532, 111–27.
[549] Erwin, n 544 535–548.
[550] However, in response to the clamorous ratification by Enron's board of waivers of conflict-of-interest provisions of its code of ethics (Christopher J Gyves, 'The Enron Failure and Corporate Governance Reform', Wake Forest Law Review (2003), *38*, *3*, 855–84) most codes now require a prompt disclosure of the waiver to shareholders. See Reed Abelson, 'Enron's collapse: the directors. One Enron Inquiry Suggests Board Played Important Role, The New York Times, 18

dangerous practice, which compromises the seriousness of the values declared in them.[551] Thirdly, the level of internalization of the codes' values and rules within the organization is low for lack of sufficient knowledge.[552]

Internalization of values, based on an Aristotelian approach, could be enhanced through education and training,[553] ethics and compliance programs,[554] morally oriented conversation,[555] and slower decision-making processes.[556] Recalling values established in the code of ethics can also induce executives to take moral issues into account in their decision-making processes.[557] In fact, some experimental researches proved that students tend to cheat less in performing tasks when they are asked to recall moral considerations and principles, whether it is the Ten Commandments or a code of honour.[558] Codes should be enforced, which means that any wrongdoing should immediately be reported and measures taken,[559] and senior managers should demonstrate commitment to the code by supporting its diffusion and enforcement.[560]

Stakeholders' pressure, especially from customers, shareholders, suppliers, and employees, also turned out to be beneficial to incorporate the ethical principles mentioned in a code in the managers' strategic decision-making,[561]

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January 2002; Note, 'The Good, the Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behaviours', *Harvard Law Review* (2003), *116*, 7, 2123–41.

[551] *See* Gregory Unruh, 'Why Code of Ethics "Safety Valves" Are Big Mistakes', The Huffington Post (14 July 2010), available at http://www.huffingtonpost.com/gregory-unruh/why-code-of-ethics-safety_b_645913.html, accessed 30 October 2018.

[552] Patrick E Murphy, 'Corporate Ethics Statements: Current Status and Future Prospects', *The Journal of Business Ethics* (1995), *14*, 727–40; Isaac D Montoya and Alan J Richard, 'A Comparative Study of Codes of Ethics in Health Care Facilities and Energy Companies', *Journal of Business Ethics* (1994), *13*, 713–17.

[553] Susan L Harrington, 'What Corporate America is Teaching About Ethics', *Academy of Management Executive* (1991), *5*, 1, 21–33; John Thomas Delaney and Donna Sockell, 'Do Company Ethics Training Programs Make a Difference? An empirical Analysis', *Journal of Business Ethics* (1992), *11*, 9, 719–27; Stevens et al, n 543, 181–95; Schwartz, n 533, 323–43; Stead, Worrell & Stead, n 420, 233–42.

[554] Ethics Research Center, 'Global Business Ethics Survey 2016', Ethics & Compliance Initiative.

[555] Max Messmer, 'Does Your Company Have a Code of Ethics?' (2003), *Strategic Finance 84*, 10, 13–14; Dan Awrey, Blair & Kershaw, n 547.

[556] Stevens et al, n 543, 181–95.

[557] FCA, n 480.

[558] Nina Mazar, On Amir, and Dan Ariely, 'The Dishonesty of Honest People: A Theory of Self-Concept Maintenance', *Journal of Marketing Research* (2008), 635–637.

[559] Messmer, n 555 13–14; Schwartz, n 533, 323–43; Pitt & Groskaufmanis, n 542, 1559–654.

[560] Montoya & Richard, n 552, 713–17.

[561] *See*, e.g., Kaptein & Schwartz, n 532, 111–27; and Stevens et al, n 543, 181–95.

while pressure from non-market stakeholders (regulatory agencies, public institutions, and government bodies) proved to have no influence.[562] The development phase of the code is also crucial for shaping personnel conduct. The drafting of the code should include managers[563] and employees' active participation[564] and the provision of many behavioural examples in order to offer the employees real-life examples of ethical/unethical conduct.[565] Codes should also be tailored specifically to the culture of the company, avoiding simply copying codes already issued by other companies.[566] Codes should be periodically revised[567] and the company should establish a monitoring system over compliance with them,[568] including effective reporting channels for employees. The ways in which reports of violations are coped with and how disciplinary procedures are carried out should also be carefully and seriously designed. In the Wells Fargo scandal, for example, an ethics hotline was established, but calling this number or trying to contact the human resources department would have cost employees their jobs.[569]

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[562] Murphy, n 552 727–40; Stevens et al, n 543, 181–95.
[563] Stead, Worrell & Stead, n 420, 233–42.
[564] Earl A Molander, 'A Paradigm for Design, Promulgation and Enforcement of Ethical Codes', *Journal of Business Ethics* (1987), *6*, 619–631; Montoya & Richard, n 552, 713–17; Messmer, n 555, 13–14; Kaptein & Schwartz, n 532, 111–27; Schwartz, n 533, 323–43.
[565] Ahluwalia et al, n 546; Murphy, n 552, 727–40; Schwartz, n 533, 323–43.
[566] Pitt & Groskaufmanis, n 542, 1559–654.
[567] Patrick E Murphy, 'Implementing Business Ethics', *Journal of Business Ethics* (1988), *7*, 907–15.
[568] Alan Doig and John Wilson, 'The Effectiveness Of Codes Of Conduct', *Business Ethics* (1998), *7*, 3, 140–9. See also Geneviève Helleringer & Christina Skinner, 'Conflicts of Interest: Comparing Compliance and Culture in the United States and the United Kingdom', in D. Busch, G. Ferrarini and G. van Solinge (eds), *Governance of Financial Institutions*, Oxford University Press, 2019, *Forthcoming*.
[569] *See*, e.g., http://money.cnn.com/2016/09/21/investing/wells-fargo-fired-workers-retaliation-fake-accounts/index.html, accessed 7 October 2018 and https://www.nytimes.com/2016/10/12/business/dealbook/at-wells-fargo-complaints-about-fraudulent-accounts-since-2005.html?_r=0, accessed 7 October 2018.

## Chapter IV

## Incentive compensation

2.4.1 Introduction. – 2.4.2 Bankers' compensation between supervision and regulation. – 2.4.3 Bankers' Pay in the EU Framework. – 2.4.4 Rethinking incentives: employing motivational theories from psychology. – 2.4.5 A broader perspective.

### 2.4.1 Introduction

As I explained before (see Section 1.1.3), bad compensation policies and incentives schemes were identified among the major failures of corporate governance of banks during the crisis. In fact, distorted incentive schemes conducted to excessive risk-taking, exacerbating bankers' moral hazard,[570] even though they succeeded in aligning CEOs' interests with shareholders' interests, as most of CEOs had large equity stakes in their own institutions.[571] And this can be easily explained, since banks shareholders' are more prone to high risk-taking and the application of traditional corporate governance best practices – requiring the alignment of managers' and shareholders' interest – reveals itself to be inadequate to banking industry, since it drove managers to focus only on short-term returns.

However, other scholars recall how executives at troubled banks such as Bear Stearns and Lehman Brothers were also "able to cash out large amounts of bonus compensation that was not clawed back when the firms collapsed, as well

[570] *See*, for example, Kirkpatrick, n 54; Associacion of Chartered Certified Accountants, 'Corporate Governance and the Credit Crunch', November 2008, 4, https://www.accaglobal.com/content/dam/acca/global/PDF-technical/corporate-governance/cg_cc.pdf; Hopt, n 25, 10-14.

[571] *See*, for example, the empirical study conducted by Rüdiger Fahlenbrach & René M. Stulz, who found 'some evidence that banks led by CEOs whose interests were better aligned with those of theirs shareholders had worse stock returns and a worse return on equity'. Fahlenbrach & Stulz, n 62, 1. Similarly, a study by Cheng et al. on the relationship between compensation and risk-taking showed that "aggressive firms who did well in the 1990s and were 'yesterday's heroes' were the largest risk-takers and are today's outcasts in the crisis', Ing-Haw Cheng et al., 'Yesterday's Heroes: Compensation and Creative Risk-Taking' 7', NBER Working Paper No. 16176/2010, available at http://www.nber.org/papers/w16176.pdf, accessed 25 October 2018. *See* also Sanjai Bhagat & Brian Bolton, 'Financial crisis and bank executive incentive compensation', Journal of Corporate Finance (2014), 25(C), 313-341.

as to pocket large amounts from selling shares", suggesting that they were not just doing the best interests of their shareholders, but rather were blameworthy of opportunistic behaviour.[572] Obviously, incentive compensation cannot be blamed as the single factor that led to short-termism and excessive risk taking. As we have already seen (see Section 2.2.5), these are also caused by psychological traits – such as over optimism and overconfidence - and sociological bias - such as authority and conformity pressures. In this chapter, I first analyse compensation from a traditional corporate governance perspective, especially focusing on the EU framework for bankers' pay and on the institutional and doctrinal debate on the necessary regulation of bankers' compensation. It follows an analysis of remuneration from the perspective of psychologists and sociologists, aimed at revealing the cultural and behavioural factors explaining the relationship between incentives and motivation.

### 2.4.2 Bankers' compensation between supervision and regulation

After the crisis, many called for regulating banks managerial remuneration to prevent further excessive risk-taking and short-termism.

According to Bebchuk and Spamann,[573] regulating bankers pay would not lead to excessively intrusive interference of banking regulation in business decisions. According to the authors, given the strong impact financial institutions have on the economic development and growth and the systemic risks they face, they generally have to be subject to a tougher regulation – especially in relation to capital and liquidity requirements - compared to non-financial institutions. In particular, the authors propose that executive pay should be tied to the aggregate value of a basket of securities (common shares, preferred shares and bonds) instead of equity alone, since the suggested 'compensation structure would expose executives to a broader fraction of the

[572] Lucian Bebchuk et al., 'The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008', Yale Journal on Regulation (2010), 27, 257, 257–82.
[573] Lucian Bebchuk & Holger Spamann, 'Regulating Bankers' Pay', The Georgetown Law Journal (2010), 98, 247, 247–87.

negative consequences of risks take' and ultimately 'reduce their incentives to take excessive risks'.[574] However, some commentators argue that this model does not take into consideration creditors' interest and work as to avoid excessive risk tanking.[575]

Similarly, Bolton et al[576] propose a CEO compensation model tied not only to equity, but, at least partially, also to a measure of default riskiness of the firm, such as a bank's credit default swap ("CDS"). The authors argue that regulation is the only way optimal incentives can be established in banks, since the traditional theory of executive compensation does not apply and since "shareholders suffer from a commitment problem in the model, which may be exacerbated by either the renegotiation of compensation contracts, deposit insurance, or naive debtholders".[577]

Tung agrees with the idea that CEOs should be paid not only with equity but also with debt, in particular with public subordinated debt securities, in order to prevent excessive risk-taking and align their interests more closely with those of debtholders[578]. Moreover, the author considers strict regulatory mandates 'inadvisable' and suggests that regulators should "offer guidelines and regulatory incentives to encourage appropriate amounts of subordinated debt in bankers' pay arrangements", but "preserving the discretion of boards of directors to set pay".

Gordon, criticizing Bebchuck and Spamann's model, builds a compensation mechanism based on convertible equity-based pay,[579] in particular on equity that will convert into subordinated debt upon certain external triggering events concerning the decline in the firm performance.

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[574] *Id.*, 236-37.
[575] Frederick Tung, 'Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation', Emory Public Law Research Paper No. 10-93 (2010); Jeffrey Gordon, 'Executive Compensation and Corporate Goverance in Financial Firms: The Case for Convertible Equity-based Pay', Columbia Law and Economics, Working Paper No. 373, 2010.
[576] Patrick Bolton et al., 'Executive Compensation And Risk Taking', Fed. Reserve Bank of N.Y.C Staff Report No. 456/2010, available at http://www.ny.frb.org/research/staff_reports/sr456.pdf, accessed 26 October 2018.
[577] *Id.*, 3.
[578] Tung, n 575.
[579] Gordon, n 575

Recently, Thanassoulis and Tanaka proposed a new compensation model[580] based on the imposition, by the regulators, of malus and clawback measures, integrated by mandatory restrictions on pay convexity. In fact, shareholders may use convex pay to circumvent the regulation imposing the enforcement of malus and clawback (but also but also of debt-linked pay and bonus caps), therefore undermining the efficacy of these compensation solutions in reducing excessive risk-taking.

On the contrary, Baghat and Romano[581] suggest that incentive pay should be based on restricted stocks and restricted stock options, that means that executives would be able to sell or exercise their stock option only after from two to four yeas following their retirement. However, the deferred award would weaken incentive, but also push executives to retire earlier.[582]

All the described models more or less explicitly lean towards a regulatory approach to incentive pay. However, this position is not unanimously shared by scholars. Ferrarini and Ungureanu,[583] for example, argue that bankers' managerial incentives should be monitored by supervisory authorities, whereas the design of the same should be left to board determination. In the authors' opinion, the designing of compensation schemes needs a certain level of flexibility – required by the different characteristics of financial firms and of circumstances – and competence that regulators is not able to fulfil.[584] Regulators should offer a 'menu' of choices that however "could hardly cover all situations that may exist in practice' and that would in any case 'dilute the impact of regulation". Moreover, this would provoke a migration of managerial talents who would move to other more attractive countries where compensation is less regulated. I personally disagree in respect to this last point, or, at least, I think that ways to attract and retain talents is not only based on financial terms (see Section 2.4.5). The authors conclude that regulators should take into

[580] These are ex post compensation adjustments made in the event of poor performance caused by misconduct or failure in proper oversight and risk management.
[581] Sanjai Bhagat and Roberta Romano, 'Reforming Executive Compensaion: Focusing and Committing to the Long-Term', *Yale Journal on Regulation* (2009), 25, 361.
[582] Tung, n 575.
[583] *See* Ferrarini &Ungureanu, n 51, 432-502.
[584] *Id.*, 451.

account managerial incentives, but 'this should be done in ways that are appropriate for prudential regulation, which typically established conditions and limits to risk taking, rather than by fixing the incentive structures directly'.[585] In addition, regulating corporate governance of banks, including compensation governance, is a better choice than imposing pay structures, especially if complemented with a stronger prudential supervision. Finally, the board itself should be left with a strong discretionary power in designing bankers' pay, since it can better understand their firm conditions.

### 2.4.3 Bankers' Pay in EU Framework

In line with the regulatory approach adopted by the EU regulators in designing the corporate governance of banks already described (see 1.2.3.1.), compensation too has been subject to detailed rules that do not only reflect FSB principles and standards but impose also stricter rules on variable compensation, all aimed at discouraging risk-taking that exceeds the level of institutions' 'tolerated risk'. In particular, the EU intervened by establishing: (a) limits to compensation as a proportion of capital;[586] (b) cap on variable compensation;[587] (c) limits on bonus structure;[588] (d) restriction and deferral of variable compensation[589]; and (e) clawback of variable compensation.[590] The current EU approach, based on these strict requirements – especially in relation to the cap on variable pay – deprive supervisory authorities of any discretionary power in its monitoring activity.[591]

[585] *Id.*
[586] CRD IV, Article 94(c).
[587] Variable compensation should respect a 1:1 ratio with respect to fixed compensation. However, with shareholder approval by a super majority, a ratio 1:2 will be permitted. *See* CRD IV, Article 94(g)(i)-(ii).
[588] CRD IV, Article 94(iii).
[589] CRD IV, Article 94(l)(m).
[590] CRD IV, Article 94(n).
[591] Guido Ferrarini and Fabio Recine, 'The Single Rulebook and the SSM. Should the ECB have More Say in Prudential Rule-making?, in D. Busch and Guido Ferrarini (eds), *European Banking Union*, Oxford University Press, 2015, 134-135.

Interestingly, the EU initially adopted a supervisory approach to remuneration in the 2009 'Commission Recommendation on remuneration in the financial sector'.[592] At the meantime, the Committee of European Banking Supervisors (CEBS) issued high-level principles for remuneration policies at banks.[593] However, the shortcomings encountered in the implementation of such standards, together with public pressure, lead to a change in the approach,[594] as shown with the adoption of CRD III in 2010 (revised in 2013 with the CRD IV package)[595] that laid down the foundations for the current legislation.[596]

In relation to the most discussed provision – the introduction of a cap on variable compensation – some commentators warned that it may have detrimental effects, especially in terms of risks. Murphy,[597] for example, argued that even though the bonus cap was introduced in order to avoid excessive risk taking, this limitation could hardly fulfil the objective, since, first of all, the introduction of the cap would simply translate into an increase in the amount of fixed pay that would make banks more vulnerable to business cycles and subject to risk failure. This prediction was confirmed by the increase in fixed remuneration registered by EBA in a report published in 2016.[598] Secondly, if the traditional bonus system at investment banks – characterized by below-market salaries and high bonus opportunities – provided incentives to avoid bad risks and take good risk, the new capped bonus system would lead bank managers to take "bad" risks and avoid the "good" ones.[599] Moreover, a compensation policy less related to performance would push away high talented investment bankers,

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[592] *See* Commission Recommendation on remuneration policies in the financial sector, [2009] OJ L 120/22.

[593] *See* CEBS, 'High-Level Principles for Remuneration Policies', 20 April 2009 (available at https://www.eba.europa.eu/documents/10180/16094/High-level+principles+for+remuneration+policies.pdf, accessed 23 October 2018.

[594] Ferrarini & Recine, n 591, 134-135.

[595] Directive 2010/76/EU of the European Parliament and the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies.

[596] For a detailed history on regulation of bankers' compensation both in US and E, see Kevin J Murphy, 'Regulating Banking Bonuses in the European Union: A Case Study in Unintended Consequences', European Financial Management (2013), 19, 631.

[597] *Id.*

[598] EBA, Report Benchmarking of remuneration practices at the European Union level and data on high earners (30 March 2016), EBA-OP-2016-05.

[599] *Id.*

who would have better employment opportunities in non-EU banks or non-bank financial operators. Ultimately, a 'one-size-fits all' approach for all credit institution, regardless of size and risk exposure, is undoubtedly too rigid, and does not respect the proportionality principle. Accordingly, the EBA suggested that the European Commission shall introduce legislative amendments on 'specific exemptions…for certain institutions that do not rely extensively on variable remuneration and, if confirmed by further analysis, also for identified staff that receive only a low amount of variable remuneration'.[600]

By agreeing with Ferrarini and Ungureanu' position, I consider regulation alone inadequate to 'adjust' bankers misconduct and high risk-taking. Bankers themselves, in particular members of the boards, are in the best position to encourage a more responsible risk management, since, as claimed by Hill and Painter, "even where law is able to specify what banks should not be doing, enforcement is often exceedingly difficult" as "banks have many ways to obscure, if not conceal, what they are doing".[601] Hence, regulation should be complemented with a strong supervisory activity on bankers behaviour and culture. Moreover, notwithstanding the fact that incentive compensation was originally designed to align the interests of managers with those of shareholders, in my opinion even this attempt to re-address their interests towards the long-term interests of debt holders cannot change the risk prone attitude of bankers that may be willing to risk losing part of their compensation. The hiring and training functions are again in charge of choosing and coaching responsible bankers.

In this regard, a study of the main determinants of motivation and of the psychology of reward is an essential condition to fully understand the issue.

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[600] *See* EBA Consultation Paper on Draft Guidelines on sound remuneration policies, n 35, Title II, chap 8, No 72; and EBA press release of 4 March 2015, available at http://www.eba.europa.eu/-/eba-reviews-guidelines-on-remuneration-policies), accessed 30 October 2018.

[601] Claire A. Hill and Richard W. Painter, *Better Bankers, Better Banks. promoting Good Business through Contractual Commitment*, University of Chicago Press, 2015, 7.

### 2.4.4 Rethinking Incentives: Employing Motivational Theories from Psychology

Remuneration is a complex issue, which needs a trans-disciplinary approach in order to be thoroughly understood and tackled. However, most of the studies mentioned above are largely based on the common assumptions of the agency cost theory.

According to the agency cost theory,[602] incentive compensation is traditionally regarded as the fundamental means for aligning the interests of shareholders and managers, on the assumption that individuals are rational and mere self-interested utility maximisers. However, there are limitations to this approach. Firstly, this usually focuses on executive remuneration, without considering the compensation of 'non-boardroom' or less senior employees,[603] who are however taken into account by financial regulation to the extent that they are risk-takers, since – as we have already seen (see 1.2.3.2.1) – they were frequently responsible for misbehaviour.[604] In addition, agency theory tends to overlook that compensation might be influenced by group dynamics and social context.[605] For instance, O'Really and Main[606] argue that CEOs may influence the board of directors when determining their compensation through two psychological mechanisms. The first is reciprocity, as shown by the evidence that CEOs receive higher cash compensation when the Chairman of the compensation committee is remunerated more. The second mechanism is social influence, as

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[602] Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure', Journal of Financial Economics (1976), 3, 305–60; Eugene Fama, 'Agency Problems and the Theory of the Firm', Journal of Political Economy (1980), 88, 288–307; Eugene Fama and Michael C Jensen, 'Separation of Ownership and Control', Journal of Law and Economics (1983), 26, 327–49.

[603] *See* Armour et al., n 2.; and Ian Larkin, Lamar Pierce, and Francesca Gino, 'The Psychological Costs of Pay-For-Performance: Implications for the Strategic Compensation of Employees', Strategic Management Journal (2012), 33, 1194–214.

[604] *See* Guido Ferrarini, 'Compensation in Financial Institutions', in D. Busch, G. Ferrarini and G. van Solinge (eds), *Governance of Financial Institutions*, Oxford University Press, 2019, *Forthcoming*.

[605] *See* Larkin, Pierce and Gino, n 120, 1194–214; and John Roberts, Terry McNulty, and Philip Stiles, 'Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom', British Journal of Management (2005), 16, 5–26.

[606] Brian G Main, Charles A O'Reilly, and James Wade, 'Economic and Psychological Perspectives on CEO Compensation: A Review and Syntheses', Industrial and Corporate Change (2010), 9, 3, 675–712.

shown by the fact that CEOs' compensation is higher when they also serve as board chairmen (a practice which is however open to criticism).[607] According to Pepper, another crucial factor is represented by subjective fairness: executives are more concerned about the perceived fairness of their incentive pay in comparison to their peers instead of the total amount of it.[608] And as for deferred incentive remuneration – provided in FSB standards and now mandatory within CRD IV framework – the author argues that executives are "very high time discounters", which means that they are not motivated by the expectation of receiving an award in a very distant future, as this tends to lose its value.[609] This argument is confirmed also by a global survey conducted among financial services executives by PWC and the London School of Economics in 2011.[610] As a consequence, if deferring the award may be more effective in preventing short-termism and excessive risk-taking, at the meantime it might lose its very first function as motivating employees working somehow harder or better. The illogical outcome is that "companies are paying people in a currency they don't value".[611]

In other words, under the agency cost theory, culture and psychological dynamics of the firm are not considered, even though culture represents 'the connector between incentive and actions'.[612]

Agency theory also overlooks the fact that the link between money, motivation, and performance does not always work in the direction that might be expected. Economists, with the exception of behaviourists, often do not consider the psychological mechanisms that limit rationality and therefore the reaction to

[607] *Ibid.*
[608] Alexander Pepper, 'Applying economic psychology to the problem of executive compensation', The Psychologist-Manager Journal (2017), 20, 4, 195-207. This study found empirical support by the global survey conducted jointly by PWC and the London School of Economics that involved 1,106 executives. See PWC, 'Pay: what motivates financial services executives? The psychology of incentives' (2012), and by the study conducted Marco van Herpen, Marco and Mirjam van Praag & Kees Cools, Kees, 'The Effects of Performance Measurement and Compensation on Motivation: An Empirical Study', De Economist (2005), 153, 3,available at https://ssrn.com/abstract=417355, accessed 1 November 2018.
[609] Pepper, n 608.
[610] PWC, n 608.
[611] Pepper, n 608.
[612] Andreas Dombret, 'Why Focus on Culture?', in Patrick S Kenadjian and Andreas Dombret (eds), *Getting the Culture and the Ethics Right—Towards a new age of responsibility in banking and finance*, De Gruyter, 2016, 15.

economic incentives.[613] In other words, the pay-for performance equation may not work in many cases. Even behaviourists, who are supporters of incentive pay model, underestimate the fact that incentives "do not create an enduring *commitment* to any value or action"[614] but just alter behaviour, therefore leading only to a temporary compliance to a stimulus, not a change in a firm culture.

Kamenica, by reviewing experiments in social psychology, identified four situations in which the idea that monetary incentives lead to better performance may fail.[615] Motivation and performance may decrease when: (i) the task is inherently interesting, but monetary incentives are introduced after a certain period of time;[616] (ii) the task is noble and money is paid;[617] (iii) the salary is either too high;[618] or (iv) too low.[619]

The experimental studies on which these findings are based often focused on tasks of a kind very distant from those usually performed in the financial sector. They nonetheless show the complex relationship between monetary incentive and motivation. Besides, empirical evidence confirms these psychological findings by showing that monetary incentives are not always associated with increased effort and, therefore, better performance. For example, Bonner et al, by reviewing 131 laboratory studies on incentives, found that incentives improved performance only in half of the studies and that the positive effect of monetary incentives decreased as the complexity of the task increased,

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[613] Christopher Hodges, *Law and Corporate Behaviour*, Hart, 2015, 25.

[614] Alfie Kohn, 'Why Incentive Plans Cannot Work' (1993), available at https://hbr.org/1993/09/why-incentive-plans-cannot-work, accessed 24 October 2018.

[615] *See* Emir Kamenica, 'Behavioural Economics and Psychology of Incentives', Annual Review of Economics (2012), 4, 13.1–13.26.

[616] Through some laboratory experiments, Deci found that when money is used as an external reward for an intrinsically interesting activity, people's intrinsic motivation for performing that activity decreases: Edward L Deci, 'The Effects of Externally Mediated Rewards on Intrinsic Motivation', Journal of Personality and Social Psychology (1971), 18 (1), 105–115.

[617] In an experiment, Titmuss found that when the task is noble (in the experiment, the task represented was to undergo some exams to become blood donors), under some circumstances the introduction of monetary incentive decreased women's inclination to perform the task. See Richard Titmuss, *The Gift Relationship: From Human Blood to Social Policy*, Allen & Unwin, 1970.

[618] 'Paying a very high wage contingent on the successful completion of a task can lead the worker to become so nervous that she is unable to get the task done', *see* Kamenica, n 614.

[619] Many experiments suggested that offering no money is better than too little. *See ibid.*

where good cognitive strategy skills instead of strong motivation was required.[620]

Bénabou and Tirole similarly stress that, because of the 'forbidden fruit' psychological principle, high rewards are associated with less attractive tasks and that offering rewards can be counterproductive in the long run, even though it can boost performance as an immediate effect.[621] Other scholars confirm this assumption that is based on the simple fact that when an activity is presented as a means towards something else, then it becomes less desirable, since individuals "infer that the activity must be difficult, tedious, risky or unpleasant in some way".[622]

Similarly Deci, on the basis of several experiments, showed that certain external monetary rewards, at given stages, decrease the intrinsic motivation, in opposition to other non-monetary rewards, such as social approval, because of people's perception of the locus of control (the rationale) of their behaviours.[623] In particular, receiving a reward would send an unconscious message to our brain, that is that our behaviour is controlled. And from the fact that the more we perceive being controlled, the less we will be interested in what we are doing, it derives that getting a bonus for our job won't make us work better.[624] This 'overjustification effect' was further analysed and other studies specified how money can have a positive or negative effect, depending on the moment it is offered and the related information to agents.[625] As intrinsic motivation is built on the need for self-determination and competence/mastery, monetary

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[620] *See* Sara E Bonner et al, 'A Review of the Effects of Financial Incentives on Performance in Laboratory Tasks: Implications for Management Accounting', Journal of Management Accounting Research (2000), 13, 19–64. *See* also Colin F Camerer and Robin M Hogarth, 'The Effects of Financial Incentives in Experiments: A Review and Capital Labor Production Framework', Journal of Risk and Uncertainty (1999), 19, 7–42; Karl Duncker, 'On Problem Solving', Psychological monographs (1945), 58.

[621] Roland Bénabou and Jean Tirole, 'Intrinsic and Extrinsic Motivation', The Review of Economic Studies (2003), 70, 3, 489–520.

[622] Jonathan L. Freedman, John A. Cunningham & Kirsten Krismer, 'Inferred Values and the Reverse-Incentive Effect in Induced Compliance', Journal of Personality and Social Psychology (1992), 62, 357-368.

[623] Deci, n 616, 105–115.

[624] Edward Deci & Richard Ryan, 'Intrinsic Motivation and Self-Determination in Human Behavior', Contemporary Sociology (1985), 3, 2, 231-242.

[625] Uco J Wiersma, 'The Effects of Extrinsic Rewards in Intrinsic Motivation: A Meta-Analysis', Journal of Occupational and Organizational Psychology (1992), 65, 2, 101–14.

incentives can either increase intrinsic motivation, if perceived as providing information about the agents' ability, or be counterproductive if seen as a means of control.[626]

### 2.4.5 A broader perspective

Motivational processes, therefore, should be at the core of studies on incentive schemes, especially with reference to non-boardroom and non-executive employees. In 1943, Maslow had already developed a motivational theory according to which human beings satisfy three related sets of personal goals, in the following order: basic (physiological and safety) needs; psychological (esteem and belongingness) needs; and self-fulfilment needs.[627] In this hierarchical model, based on the Aristotelian approach,[628] the necessities at the top cannot be satisfied without first realizing those on lower levels. When applied to compensation issues, this theory suggests that employees should be paid fairly and that the working environment should enhance security and a culture of respect and dignity for all team members, rather than promoting aggressiveness and sense of danger. In addition, employees should receive periodic feedback concerning their work and be motivated through a prospect of self-potential achievement.

Similarly, Herzberg's Two-Factors Theory[629] specifically addressed employees' motivational strategies. Herzberg viewed basic needs (such as those related to working conditions, status, job security, salary, and fringe benefits) as simple hygiene factors, the absence of which may create dissatisfaction, but the increase of which does not boost motivation. Being indispensable, they are different from other factors (such as recognition, good relationships, and growth potential) that provide extra-motivation. In simple terms, once people get paid

[626] Bruno S Frey & Felix Oberholzer-Gee, 'The cost of price incentives: an empirical analysis of motivation crowding-out', The American economic review (1987), 87, 746-755.
[627] Abraham H Maslow, 'A Theory of Human Motivation', Psychological Review (1943) 50, 370–96.
[628] Maslow often cited Aristotelian moral philosophy in his studies. *See* Abraham H Maslow, *Motivation and personality*, Harper and Row, 1987, 3, 270–71.
[629] Frederick Herzberg, Bernard Mausner, and Barbara Bloch, *The Motivation to Work*, Wiley, 1959.

enough, money stops being a substantial driver of engagement. Moreover, satisfaction and dissatisfaction are not necessarily interrelated. Getting promoted, for example, does not decrease the dissatisfaction deriving from bad working conditions, and an increase in salary does not translate into job satisfaction when there is great deal of tangible tension among colleagues.

Furthermore, several factors – in addition to and sometimes more effectively than money and rewards – can be decisive in inducing people to act in a given way, such as making a desired behaviour the default option or performing priming interventions.[630] Delegating and giving more autonomy can boost the agents' intrinsic motivation, self-confidence, and self-determination, if perceived as an expression of trust in the agents' professional skills and competence.[631] Providing good and immediate feedback may also help employees to better internalize certain practices.[632] Of course, whether similar steps are successful also depends on the nature of the tasks and may be more effective in jobs involving creative skills.[633] In addition, modifying situational factors can influence decision-making processes under so-called 'choice architecture'.[634]

As a consequence, those who criticise certain remuneration models that would create problems in attracting and retaining managerial talents (see Section 2.4.2) should take into consideration also non-monetary criteria that are usually evaluated for choosing a job. A clear example is offered by the recent competition between banks and tech firms. Indeed, MBA high-potential graduates seem now to be keener to choose a job in the high-tech sector instead of joining the financial industry.[635] Money is of course taken into consideration, but other elements such as innovation, a deeper sense of purpose, better working

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[630] Through a priming intervention a person's behaviour can be influenced by exposing him to a particular stimulus, in an explicit, implicit, or subliminal way. See Kamenica, n 614.

[631] *See* Bénabou & Tirole, n 621, 489–520.

[632] Richard H Thaler and Cass R Sunstein, *Nudge*, Yale University Press, 2008, 82.

[633] David M Kreps, 'Intrinsic Motivation and Extrinsic Incentives', The American Economic Review (1997), 87, 2, 359–64.

[634] FCA, n 480. *See* also, e.g., Robert B Cialdini, *Influence: The Psychology of Persuasion*, William Morrow, 1993.

[635] *See* Laurence Fletcher and Pat Minczeski, 'Why Banks Are Losing the Battle for M.B.A. Talent', The Wall Street Journal, 6 June 2018, available at https://www.wsj.com/articles/why-banks-are-losing-the-battle-for-m-b-a-talent-1528277402, accessed 24 October 2018; Jonathan Moules, 'Banks try to lure MBA graduates away from Big Tech', The Financial Times, 15 January 2018, https://www.ft.com/content/69f7bbf6-f55d-11e7-8715-e94187b3017e, accessed 24 October 2018.

environment and flexibility are relevant incentives, especially for Millenials.[636] Undoubtedly, the high number of financial scandals could have played a role in lowering the reputation and promoting distrust towards banking career.

The history and values of each national culture also interferes with the way in which motivation and economic incentives determine individual behaviour. In China, for example, people have weak trust in government and politics, which makes some indirect and long-term benefits (such as life insurance, education subsidy and vacation leave) less attractive and motivating to Chinese people[637] than short-term compensation in cash, bonuses, or housing.[638] Further examples of how compensation structures are linked with the diverse social values engrained in national cultures were offered by other scholars[639] based on the cultural dimensions theory developed by Hofstede.[640] Organizations in high power distance countries, such as France, have higher CEO pay and a lower proportion of variable pay over total compensation than low power distance countries such as Sweden. Similarly, more individualistic countries, such as the United States, show higher CEO pay and higher proportion of variable compensation to total CEO compensation than collectivist countries, such as Taiwan. Societies high in uncertainty avoidance, such as Japan and Germany, present a lower proportion of variable compensation to total compensation than countries with weaker compliance to rules and authority, such as the United States. Consistently with these findings, Herkenoff found that a rather strong collectivist culture in Zanzibar drove local employees of a Swiss-owned company to prefer an hourly wage rather than the pay-for-performance compensation

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[636] *See* PWC, n 608.

[637] Randy K Chiu, Vivienne Wai-Mei Luk, and Thomas Li-Ping Tang, 'Retaining and motivating employees. Compensation preferences in Hong Kong and China', Personnel Review (2002), 31, 4, 402–31.

[638] Martin J Conyon & Lerong He, 'CEO Compensation and Corporate Governance in China', Corporate Governance: An International Review (2012), 20, 575–92; and Chiu, Luk, & Tang, n 637, 402–31.

[639] Henry L Tosi & Thomas Greckhamer, 'Culture and CEO Compensation', *Organization Science* (2004), 15, 6, 657–70.

[640] Hofstede, n 275.

offered to them.[641] In addition, every week they pooled all wages earned and divided them up equally amongst all employees.

Motivation varies within groups working at different levels of an organization too, and in different historical periods.[642] Surveys conducted for 1946, 1980, 1986, and 1992 on motivational factors in the work environment revealed how motivational determinants change over the years[643] and vary especially in relation to the gender, income, and occupational position of individuals.[644]

To draw a preliminary conclusion, remuneration and incentives are multifaceted concepts. Far from suggesting a radically new model of compensation, it is recommended that firms in general and financial institutions in particular start abandoning the outdated model of executive agency, and follow an approach where the actual psychological mechanisms and the cultural factors influencing people's motivation and decision making are duly taken into account. Is monetary reward itself the best way to motivate people doing high-quality work? Or is it not so different from punishment as a manipulative mechanism, where the threat of "no reward" is implied?[645] How can it be that economic studies on incentive pay have for decades paid attention only to how to create the most effective composition of pay packages without never questioning the fact that adding quantitative rewards to increase the quality of job performance may not work? What I suggest is that economists should start integrating the last thirty years of empirical psychological research in their analyses and begin to consider alternative and more effective ways to motivate people. Future practices will also benefit from advances in neurosciences, given that brain scanning methods and other techniques are already showing the

[641] Linda Herkenhoff, 'Culture: The Missing Link Between Remuneration and Motivation', World at Work Journal Third Quarter (2014), 6–15.
[642] Carolyn Wiley, 'What Motivates Employees According to Over 40 Years of Motivation Surveys', International Journal of Manpower (1995), 18, 3, 263–80.
[643] In 1946, the most important factor among employees was represented by appreciation for the work done; in 1980 and 1986, having interesting work was decisive; and in 1992, a good wage became the factor of major concern.
[644] In the 1992 survey, results showed that women gave more importance to appreciation than males, who were more concerned about interesting work; sympathy in understanding personal problems was particularly significant for low income groups and plant employees.
[645] Kohn, n 614.

biases on which current reward policies are built[646] and the reasons why an evidence-based approach would be preferable. Also, regulation in this sector should be reviewed, starting from the international principles, since motivational factors depend on national cultures, gender, and occupation of the individuals concerned, and time in history. Finally, deferred incentive pay, even though can prevent executives from taking too high risks, might not work as incentive at all.

[646] Shan Luo et al, 'Behavioral and Neural Evidence of Incentive Bias for Immediate Rewards Relative to Preference-Matched Delayed Rewards', The Journal of Neuroscience : The Official Journal of the Society for Neuroscience (2009), 29, 47, 14820, available at http://doi.org/10.1523/JNEUROSCI.4261-09.2009, accessed 2 December 2018.

# Chapter V

## The Role of Institutional Investors and Supervisory Authorities

2.5.1 Introduction. - 2.5.2 Supervisory authorities. – 2.5.2.1 The DNB example. – 2.5.2.2 The future of supervision on culture and conduct. 2.5.3 Institutional Investors.

### 2.5.1 Introduction

As suggested in the previous chapters, the board plays a fundamental role in the design, implementation and monitoring of the organizational culture within the bank. However, since culture is a multi-layered concept that develops across the entire institution and interacts with strong internal and external pressures, the board alone cannot ensure a cultural change, but rather should be supported and guided by its shareholders – especially by the so-called institutional investors – and by financial supervisory authorities.

This Chapter describes the role of institutional investors and financial supervisors in the implementation of an effective culture in financial institutions, that is to say a culture stimulating practices and behaviours that would allow each firm to reach its own goals in a responsible manner and with a long-term view.[647]

### 2.5.2 Supervisory authorities

The distrust towards banks caused by the financial crisis had negative effects on the relationship between boards and supervisors. However, since the trust in the financial sector is key to its current and future soundness, "firms and supervisors need to work together to leverage and reinforce sound industry

[647] Graham et al, n 239.

practices. There needs to be a culture of cooperation throughout the firm and industry".[648]

According to a recent study from the G30,[649] a new style of interaction is needed. In particular, 'boards and supervisors should adopt a paradigm of trust-based interaction built on clear mutual expectations and recognition of areas of mutual interest, with a focus on examining business model vulnerabilities, governance effectiveness, and culture.'[650] Supervision should not be limited to the assessment of compliance with rules, but it should rather deal with behaviours that regulation cannot control and shape. This requires the use of both formal and informal channels between senior supervisors and the supervised institutions.[651] Indeed, an excessive focus on formal requirements risks leading to a supervisory approach focused only on box-ticking.[652]

With specific reference to culture, the G30 study suggests that supervisors should identify the cultural profile of the specific bank, avoiding imposing a unique approach, since there is not only one right corporate culture for major banks. Once the board has itself identified the culture of its organization, especially its risk culture, supervisors should share their observations with the board, and detect potential culture issues that need rectification.[653] Developing better communication skills and attracting high-level staff should be priorities for supervisors. Moreover, in order to identify and assess culture, soft skills are needed both for board members and supervisors.

In 2015, the G30 specifically addressed financial cultural restoration by issuing the study 'Banking Conduct and Culture: A call for sustained and comprehensive reform'.[654] The study, based on about 500 post-crisis policy documents, found that supervisors approach culture in three distinct ways: (a) 'a default approach through conduct of business rules and standards'; (b) an approach based on the ability of supervisors to make useful observations about

[648] Institute of International Finance, 'Achieving Effective Supervision: An Industry Perspective' (2011), 28.
[649] G30, 97.
[650] *Id.*, 12.
[651] *Id.*, 21.
[652] *Id.*, 44.
[653] *Id.*, 19.
[654] G30, n 102.

the bank culture; and (c) a proactive approach formally integrating cultural consideration within the supervisory duties.[655] The third attitude, adopted by a few supervisory systems, is the only one directly dealing with cultural aspects of financial institutions. In any case, the lack of expertise and an enforcement-led approach focused more on sanction imposition than preventive supervision undermined any chance of creating a trust-based dialog between supervisors and supervised institutions. On the contrary, a clear distinction and a proper balance between supervision and enforcement is needed.[656]

However, the G30 does not suggest that supervisors should develop "a formal add-on to their methodology in order to deal with cultural issues", since this would set higher expectations than they can achieve.[657] Supervisors should rather identify bank cultural weaknesses by using various indicators (compliance failures, customer complaints, internal or external surveys, and internal) and best practices.

Following the report, the G30 registered impressive progresses in banks attitude towards conduct and culture, but also a high level of employees' scepticism and exhaustion towards cultural initiative, which risks to bring all the efforts to nothing.[658] Regulatory and supervisory authorities from may countries (i.e. United Kingdom, EU, US, Canada, Australia, Hong Kong, Singapore and China) launched a series of initiatives focusing on culture and conduct in the financial market industry.[659] Some supervisors also started to consider AI and machine learning technologies to better assess and monitor conduct risk, even though many technical and ethical issues should still be solved.[660]

Undoubtedly, the De Nederlandsche Bank (DNB) anticipated the G30 instructions by adopting a new interactive approach to banking supervision. As so, the DNB example is examined in the Section below.

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[655] *Id.*, 43.
[656] *Ibid.*
[657] *Id.*, 54.
[658] G30, n 237.
[659] *Id.*, 27.
[660] *Id.*, 23.

#### 2.5.2.1 The DNB example

In the EU, both the ECB and the EBA released many guidelines focusing on governance arrangements, addressing also cultural and conduct-related issues.[661] However, the most representative example of supervisory integration of cultural aspects and conduct assessment is by no means embodied by the DNB case.

As already mentioned in Chapter II, since 2010 the DNB has become the first banking supervisor globally to treat culture and behaviour as risk factors in supervision, as it established a DNB's Expert Centre on Governance, Organizational Behaviour and Culture.[662] In particular, the Dutch central bank moved from the belief that an effective financial supervision "needs to combine 'structural' perspectives with insights into the behavioural and cultural drivers of firm performance, in order to become more effective in fostering firm and financial stability".[663]

Since 2010 to 2017, DNB has conducted more than 100 assessments targeting banks, insurance companies, pension funds, and trust offices, that revealed how the main risks related to board culture concerned the lack of awareness – by board members - of their own behaviour and group dynamics, the presence of a dominant CEO insufficiently challenged by other board members, an ineffective adherence to strategic objectives, and an informal decision-making system.[664]

The DNB built its supervisory strategy on three basic assumptions: (1) strengthening regulation is not enough to avoid another financial crisis; (2) behaviour and culture are relevant for prudential supervision to the extent they

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[661] Consider, for example: EBA, n 137; ESMA and EBA, n 100, ESMA71-99-598 EBA/GL/2017/12; EBA, n 152; ECB, n 99; ECB, n 469.

[662] *See* AFM and DNB, n 103. Actually, the idea originated earlier, in the aftermath of Lehman's collapse. The first policy paper (DNB, 'The Seven Elements of an Ethical Culture, Strategy and approach to behaviour and culture at Financial institutions 2010-2014', available at https://www.dnb.nl, accessed 17 December 2018), was issued in 2009. For an historical overview of the origins and development of the Dutch supervision of conduct and culture, *see* Wijnand Nuijts, 'Public Supervision of Behaviour and Culture', in D. Busch, G. Ferrarini and G. van Solinge (eds), *Governance of Financial Institutions*, Oxford University Press, 2019, *Forthcoming*.

[663] *See* also Nuijts, n 662.

[664] DNB, 'Leading by Example – conduct in the board rooms of financial institutions' (2013), 19.

contribute to the construction of public trust in the financial sector, that is vital to the soundness of the financial system as a whole; and (3) behaviour and culture are part of sound business operations.[665]

As a result, according to the Dutch banking supervisor, traditional supervisory activities should be integrated with new tools for a complete assessment of financial and non-financial risks. In detail, the new model of supervision should focus on areas such as business models, board effectiveness, behaviour and culture (see Figure 1).[666]

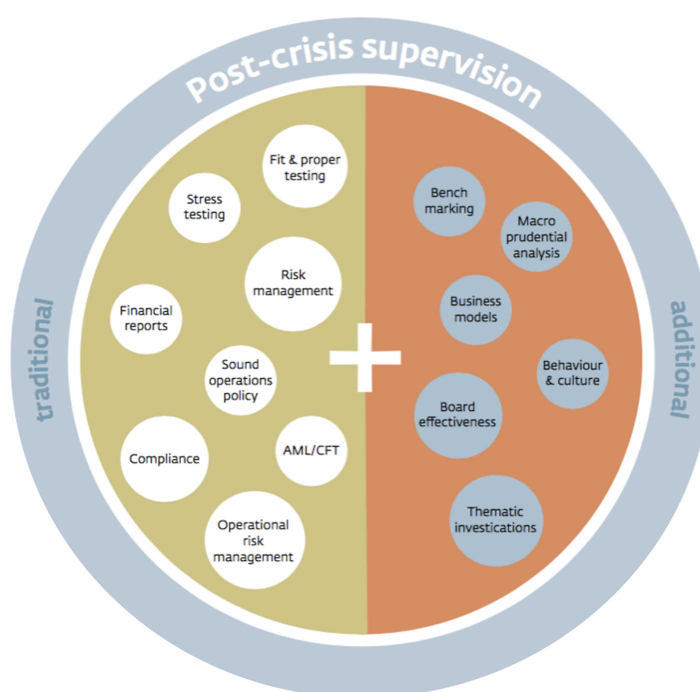


Figure 1: DNB Supervisory Approach. Source: DNB (2015)

The monitoring of institutions' organizational culture is mainly carried out by means of on-site inspections. Each on-site inspection consists of the four phases: (1) context analysis, (2) risk identification, (3) risk assessment, and 4) risk mitigation.[667] For the risk identification phase, the DNB uses a triangular approach, based on a mixture of qualitative and quantitative methods retrieved

[665] Nuijts, n 662.
[666] DNB, 'Supervision of Behaviour and Culture Foundations, practice & future developments' (2015), 11.
[667] DNB, n 666, 74.

from social sciences, such as surveys, self-assessments, semi-structured interviews, employee surveys, and board observations[668].

However, the most relevant innovation of this composite approach is the integration of psychological assessments, based on the conviction that culture – especially leadership, decision-making, communication and group dynamics – influences organisational performance. In particular, the DNB approaches culture by focusing on group behaviour and the interaction between certain individual roles and the group. Moreover, the DNB hired organizational psychologists to assess whether candidates are fit for executive office in banks and occasionally, during the board observation phase, to take part in board meetings and analyse directors' behaviour.[669] Specifically, they "…observe verbal behaviour, such as the way the board members speak to each other, the amount of time someone speaks up and the frequency, the impact of the comments made and non-verbal behaviour, such as facial expressions, posture, listening behaviour".[670]

Interviews are collected, recorded, transcribed and categorized, then triangulated with other sources of information. Throughout the entire analysis process, a continuous challenge is carried out, first amongst the experts, then between the experts and line supervisors, and finally through an independent view by experts not involved in the evaluation.[671]

After the finalization of a risk assessment, the findings are presented and discussed with the institution in a so-called challenging dialogue.[672] Then, the DNB findings, the expectations and the risk mitigation strategy are included in a written report. The risk mitigation strategy is mainly based on multiple (i.e. conditional,[673] social learning[674] or modelling, cognitive learning,[675] dual system

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[668] *Id.*, 77.

[669] *See* John M Conley and Cynthia Williams, 'Fixing Finance 2.0', in Bertram Lomfeld, Alessandro Somma, and Peer Zumbansen (eds), *Reshaping Markets. Economic Governance, the Global Financial Crisis and Liberal Utopia*, Cambridge University Press, 2016, 222.

[670] DNB, n 666, 83.

[671] Nuijts, n 662.

[672] *Id.*

[673] A learning method in which a biological stimulus – such as food – is associated to a netutral stimulus – such as a bell. This learning strategy was first theorized by Pavlov. *See* Ivan P Pavlov, *Conditioned Reflexes: An Investigation of the Physiological Activity of the Cerebral Cortex* (translated by G.V. Anrep), Oxford University Press (1927).

approach[676]) and multilevel (conscious and unconscious) interventions based on the risk category identified.[677] Interestingly, instead of focusing on indirect communication through reports and letters, direct challenging dialogue is at the core of every mitigation strategy, as it is involves feelings and emotions in addition to the rational cognitive approach that would prove inadequate for real change.[678]

Also, the DNB contributed to the development of the supervision of behavior and culture at the Dutch market conduct regulator, the AFM.[679] The DNB is also assisting other international banking authorities in introducing the assessment of culture and behaviour in their monitoring activities. Some examples are the Central Bank of Thailand, the Central Bank of Ireland and the New York Federal Reserve Bank.[680] The ECB also contributed to the integration of behavior and culture supervision in the context of the European banking supervision – which is performed by the SSM under the coordination of the ECB – with specific relation to the creation of a methodology relating to board effectiveness and change effectiveness, which were field tested at a number of EU significant banks.[681] Finally, it supported the ECB in the development of a methodology for fit and proper interviews within the fit and proper

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[674] Behavior is learned from the environment through the process of observational learning. *See* Albert Bandura, *Social foundations of thought and action: A social cognitive theory*, Prentice-Hall, Inc. (1986).

[675] This theory implies that the different processes concerning learning can be explained by analysing the mental processes (e.g. beliefs, thoughts, attitudes, feelings), based on three main variables: behavioural factors, environmental factors (extrinsic), and personal factors (intrinsic). Edward Tolman was one of the main contributors to the theory. *See* Edward C Tolman, 'Cognitive maps in rats and men', Psychological review (1948), 55, 4, 189.

[676] A learning model based both on implicit and explicit processes. *See* Robert C. Mathews, Ray Buss, William B. Stanley, Fredda Blanchard-Fields, Jeung Ryeul Cho, Barry Druhan, 'Role of implicit and explicit processes in learning from examples: A synergistic effect', Journal of Experimental Psychol- ogy: Learning, Memory, and Cognition (1989), 15, 1083–1100.

[677] DNB, n 666, 88.

[678] DNB, n 666, 92.

[679] Nuijts, n 662.

[679] *Id.*

[680] *Id.*

[681] In particular, the DNB chaired an SSM Task Force on Behaviour and Culture. *See* ECB, 'Good governance - an asset for all seasons', Keynote speech, Danièle Nouy (Chair of the Supervisory Board of the ECB), 'From Lehman to Bitcoin - trends and cycles in financial supervision', at the farewell seminar of Jan Sijbrand, (21 June 2018), available at https://www.bankingsupervision.europa.eu/press/speeches/date/2018/html/ssm.sp180621.en.html, accessed 17 December 2018.

assessment.[682]

However, the new Dutch supervisory model was not the only novelty introduced in the Netherlands. Indeed, the amendment of the Dutch Financial Supervision Act made in 2015 established the so-called 'banker's oath', an oath akin to the physician's Hippocratic Oath,[683] by which all bank employees are bound by the rules of conduct for the ethical and careful practice of their profession.[684] In 2012, the proposal by the Minister of Finance required to all employees to take the oath but, due to public criticism, in January 2013 the oath was legally required only to board members and supervisory board members. In 2015, the Minister of Finance finally extended the legal requirement to all bank employees, notwithstanding the opposition made by the Council of State.[685] To date, the oath has been taken by 87,000 Dutch bank employees.[686] In the event of refusal to take the oath or of break of the inherent duties, bank employees (but only those working in banks registered in the Netherlands) can be punished by the Banking Disciplinary Committee (*Tuchtcommissie Banken)*,[687] that can impose one or more of the following measures: (i) a compulsory training order; (ii) a reprimand; (iii) a fine of to 25,000 euros (to be paid to the FBEE); or (iv) a professional ban for a maximum of three years.[688]

Below is the text of the legally required Banker's Oath, taken by the approximately 87.000 bank employees in The Netherlands. Aside from personally signing the oath's form, employees committed themselves personally by participating in a special ceremony arranged by their employers.

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[682] *Id.*

[683] Actually, the proposal of introducing a mandatory moral and ethical declaration for bank directors was introduced among the recommendations included in the report entitled 'Towards restoration of trust and confidence', issued by the Board of the Dutch Banking Society in 2009. See Danny Busch and Peter Laaper, 'The Dutch Banker's Oath and the Dutch Banking Disciplinary Committee', in D. Busch, G. Ferrarini and G. van Solinge (eds), *Governance of Financial Institutions*, Oxford University Press, 2019, *Forthcoming*.

[684] See Tom Loonen and Mark R. Rutgers, 'Swearing to be a good banker: Perceptions of the obligatory banker's oath in the Netherlands', Journal of Banking Regulation (2016), 18, 1.

[685] *Id.*

[686] 'The Banker's Oath', Tuchtrecht Banken, Amsterdam; https://www.tuchtrechtbanken.nl/en/vragen/is-the-bankers-oath-voluntary, accessed 26 December 2018.

[687] *See* Dutch Financial Supervision Act (*Wet op het nancieel toezicht* ), Article 3:17c .

[688] Disciplinary Regulations, Article 3.9.2.. For the complete text of the Disciplinary Regulations (*Tuchtreglement Bancaire Sector*) (version 1 September 2016). *See* Busch & Laaper, n 683.

I swear / promise that, within the boundaries of my function in the banking sector, I will:

- Execute my function ethically and with care;
- Draw a careful balance between the interests of all parties associated with the business, being the customers, shareholders, employees and the society in which the business operates;
- When drawing that balance, making the customer's interests central;
- Will comply with the laws, regulations and codes that apply to me;
- Will keep confidential that which has been entrusted to me;
- Will not abuse my knowledge;
- Will act openly and accountably, knowing my responsibility to society;
- Will make every effort to improve and retain trust in the financial sector.

So help me God! / This I pledge and promise![689]

The Code of Conduct, enshrined in the Banker's Oath, specifies the following principles:

1. The bank employee works with care and integrity. This means, among other things, that the bank employee:
   - is honest and reliable;
   - prevents the conflict of his/her interests with the interests of others;
   - prevents the appearance of conflicts of interests.
2. The bank employee carefully balances interests. This means that the bank employee carefully balances the interests of the bank's customers, its shareholders, its members, its bond holders and other creditors of the bank, its employees and society as a whole.
3. The bank employee puts the customer's interests first. This means, among other things, that the bank employee:
   - offers customers the best possible information about products and services, and their associated risks;
   - does not offer customers products or services that do not suit them;
   - helps to ensure that a products do not expose customers to irresponsible risks;
   - helps to ensure that products are understandable for customers.

[689] *See* https://www.tuchtrechtbanken.nl/en/the-bankers-oath, accessed 17 December 2018.

4. The bank employee abides by legislation and other regulations that apply to the bank. This means, among other things, that when carrying out his or her duties the bank employee abides by the legislation, regulations, rules of conduct and instructions that apply to working at the bank.
5. The bank employee does not disclose confidential information. This means, among other things, that the bank employee does not provide any confidential information about customers to third parties without the customer's permission. The employee only discloses information about customers when required to do so by law, a judge or the supervisory body. The certified employee is also prohibited from misusing the information that he or she has access to.
6. The bank employee is open and honest with regard to his or her behaviour and is aware of his or her responsibility to society. This means that the bank employee allows his or her behaviour at work to be tested for adherence to these rules of conduct.
7. The bank employee contributes to promoting society's trust in the bank. This means, among other things, that when carrying out his or her duties the bank employee does not take any risks that may endanger the bank or others.[690]

At the current stage, Netherlands is the first country to have imposed such a legal requirement on the financial sector. In the UK and US, even though the introduction of a mandatory banker's oath has been proposed and discussed, it did not reach sufficient support.[691] In Australia, an oath has been introduced but on a voluntary basis.[692]

By introducing the oath, the Dutch legislator aimed at increasing the consumer trust on financial sector, especially in the light of the 2008 scandals. Notwithstanding the good intentions, the oath was subjected to wide scepticism, as well as many critics, especially in relation to its efficacy in increasing moral

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[690] *Ibid.*
[691] *See*, for the UK, 'Bankers should swear oath of good service, says thinktank' (28 Jul 2014), https://www.theguardian.com/business/2014/jul/28/bankers-swear-oath-good-service-thinktank-respublica, accessed 22 December 2018, and for the US John R Boatright, 'Swearing to be Virtuous: The Prospects of a Banker's Oath', Review of Social Economy (2013), 71, 2, 140-165.
[692] *See* Loonen & Rutgers, n 685.

judgement and ethical behaviour.[693] Moreover, it remains doubtful if bankers can be considered and treated as a uniform professional group, considered the broad range of financial products and end consumers each banker has to deal with depending on its specific role.[694] Indeed, contrary to physicians, bankers' clients cannot be unified under a category such as patients, neither they share a limited range of interests to be satisfied.[695] The issue is even more crucial in terms of liability, as there is not certainty on who should be deemed responsible for the end consumer in each complex banking procedure. Considered this difficulty in applying the ethical code in practice, some commentators even suggested that the oath could be dangerous by as it would create "a false sense of confidence that the challenge of ensuring ethical conduct has been met".[696]

In my opinion, such a oath could prove effective to a certain extent, depending on the cultural and legal framework in which it is established, but in any case as a complementary tool. Like codes of conduct and ethics (see 2.3.3.4), the main risk is that its adoption becomes a mere formality externally imposed, while only well internalized principles and practices may prove effective. Another risk is that, considered the lack of behavioural examples provided by the code and the difficulty in fully understand the liability boundaries of the oath, bankers could be disincentivised to take any risk, or simply lead to be more reluctant keeping their role in the bank, especially where a similar oath is not required in other commercial sectors.

### 2.5.2.2. The future of supervision on culture and conduct

The Dutch example shows how a less regulation-based approach to supervision should be encouraged. Some commentators even suggest that excessive regulatory burden might be the cause of misconduct, as it would force

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[693] *See*, for example, Boatright n 691, 140-165. Moreover, a survey carried out 2014 show that the trust in oath effectiveness is rather low, especially among bank employees. *See* Loonen & Rutgers, n 685.

[694] *See* Loonen & Rutgers, n 684.

[695] *See* Boatrigh, n 691, 140-165.

[696] *Id.*

employees to break the rules and choose short cuts in order to shorten long and complex procedures.[697]

Of course, changing organizational behaviour at banks and other financial institutions will take time and perseverance, as cultural change requires a deep transformation that involves not only behaviour, but also intrinsic beliefs, basic assumptions and core values. Moreover, monitoring culture and conduct requires a combination of both financial skills and social competences, as well as experience that supervisory generally do not have and that take time to develop and integrate. The financial supervisor itself should then carry out a cultural self-assessment in the first place.

The UK seems to follow the same track as the Financial Conduct Authority (FCA) – that protects consumers and promotes competition amongst more than 56,000 financial institutions in the United Kingdom -[698] has published several papers dealing with issues concerning the culture of compliance in the financial industry from the perspective of behavioural economics,[699] sociology, and psychology.[700] Moreover, in 2016 the FCA – directly targeting culture –[701] introduced the Senior Managers and Certification Regime (Accountability Regime), that replaces the UK Approved Persons Regime (APR) with a regime that is more focused on senior managers and individual responsibility. The Accountability Regime is composed of three key parts: (i) the Senior Managers Regime, (ii) the Certification Regime, and the (iii) Conduct Rules.[702] The Senior

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[697] For instance, Nuijts notices how, in order to meet too high procedural requirements, some employees at ABN AMRO decided to copy the customer's signature. *See* Nuijts, n 662.

[698] https://www.fca.org.uk/about/the-fca, accessed 30 October 2018.

[699] FCA, 'Applying behavioural economics at the Financial Conduct Authority', Occasional Paper No 1/2003, available at https://www.fca.org.uk/publication/occasional-papers/occasional-paper-1.pdf, accessed 15 November 2018.

[700] FCA, n 480; FCA, 'Incentivising Compliance with Financial Regulation', Occasional Paper No 25/2016; and FCA, 'From advert to action: behavioural insights into the advertising of financial products, Occasional Paper No 26/2017 https://www.fca.org.uk/publication/occasional-papers/op17-26.pdf, accessed 15 December 2018.

[701] Indeed, similar to the DNB, the FCA identified two main root causes for financial crises: strategy/business model and culture. *See* Speech, Jonathan Davidson 'Culture and conduct - extending the accountability regime', City and Financial Summit, London. (20 Sep 2017), available at https://www.fca.org.uk/news/speeches/culture-conduct-extending-accountability-regime accessed on 17 Dec 2018.

[702] FCA, 'Senior Managers and Certification Regime: banking', https://www.fca.org.uk/firms/senior-managers-certification-regime/banking accessed on 18 December 2018.

Managers Regime requires that each and every senior manager have clear accountabilities set out in an individual Statement of Responsibility, to prove he/she took reasonable steps to ensure that the decisions made by the people they lead are appropriate. The Certification Regime applies to all employees in positions that significantly affect conduct outcomes. Firms are responsible to ensure that people who are in significant positions of conduct are fit and proper to perform their role, by performing a specific check at least once a year. The conduct rules are a set of minimum standards that apply to almost everyone in the banking sector. However, there are also some Conduct Rules that only apply to senior managers.

The SM&CR has been in force for banks, building societies, credit unions and PRA-designated investment firms (Relevant Authorised Persons) since March 2016. The SM&CR is due to be extended to cover all FCA (Financial Conduct Authority) solo-regulated financial services firms from 9 December 2019.

Moreover, other Accountability Regimes have emerged in other jurisdictions, including Hong Kong Manager-in-Charge (effective October 2017); the Australian Prudential Regulation Authority's Banking Executive Accountability Regime (effective July 2018); and the Monetary Authority of Singapore's proposed Individual Accountability and Conduct Regime and guidance from the US Federal Reserve Bank.[703]

In order to avoid a purely formal tick-box approach by financial institutions, a certain level of certainty on the practical implementation of the same should be ensured, as well a sufficient level of flexibility on the adoption of the more suitable regime considered the specific characteristic of the institution, as has been already provided by the FCA.

In the light of the considerations above, it is clear how the role of financial supervisors is already evolving and trying to research alternative ways to better monitor financial institutions. However, only future outcomes will tell us whether the new path is going to make an effective change or new techniques should be established.

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[703] Group of Thirty (G30), n 237, 28.

### 2.5.3 Institutional Investors

Over the last decades, the rise of institutional investors as major owners of corporate shares[704] reversed the trend towards the Berle-and-Means dispersed corporations,[705] often characterized by conflicts of interests between managers and shareholders.[706] By typically owning larger blocks than individual dispersed shareholders, institutional shareholders have stronger incentives but also specialized expertise in monitoring their investments, and therefore could lead to a reduction of shirking phenomenon and of the related agency costs.[707] Interestingly, the institutionalization of ownership covered also control-oriented countries such as Germany and Italy, where blockholders, including families, the state or banks used to dominate most of the large companies.[708]

Notwithstanding the beneficial effects that this phenomenon have on the governance landscape – some of which have been confirmed by empirical studies -[709] some scholars argue that other peculiar cost-agency problems may still

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[704] Gilson and Gordon argue that this ownership change was caused by "(i) political decisions to privatize the provision of retirement savings and to require funding of such provision and (ii) capital market developments that favor investment intermediaries offering low-cost diversified investment vehicles". *See* Ronald J Gilson & Jeffrey N Gordon, 'The Agency Costs of Agency Capitalism Activist Investors and the Revaluation of Governance Rights', Columbia Law Review (2013), 113, 863.

[705] Bernard S Black, 'Shareholder Passivity Reexamined', Michigan Law Review (1990), 89, 3, 520-608.

[706] For cost-agency theory, *see* Berle & Means, n 4.

[707] Since the issuance of the Cadbury Report in 1992 policy makers and corporate governance experts advocated stronger shareholder involvement in invested companies' affairs, as a solution to high agency costs. For an historical review, *see* Brain R Cheffins, 'The Stewardship Code's Achilles' Heel', University of Cambridge Faculty of Law Research Paper No. 28/2011, available at https://ssrn.com/abstract=1837344, accessed 18 December 2018.

[708] *See* Iris Chiu & Dionysia Katelouzou, 'From Shareholder Stewardship to Shareholder Duties: Is the Time Ripe?', Nordic & European Company Law Working Paper No. 18-10/2016, available at https://ssrn.com/abstract=2731241, accessed 18 December 2018.

[709] Empirical studies found that the presence of institutional investors strongly influences governance settings, especially with reference to executive compensation, election of board members, innovation, but also management disclosure. *See*, for instance, Jay C Hartzell & Laura T Starks, 'Institutional Investors and Executive Compensation', Journal of Finance (2003), 58, 6, 2351–74; Philippe Aghion, John Van Reenen & Luigi Zingales, 'Innovation and Institutional Ownership', American Economic Review (2013), 103, 1, 277–304; Kee H Chung & Hao Zhang, 'Corporate Governance and Institutional Ownership', Journal of Financial and Quantitative Analysis (2011), 46, 1, 247-273; and Audra L Boone & Joshua T White, 'The effect of institutional ownership on firm transparency and information production', Journal of Financial Economics (2015), 117, 3, 508-533. *See contra*: Andres Almazan, Jay C Hartzell & Laura T Starks, 'Active Institutional Shareholders and Costs of Monitoring: Evidence from Executive', Financial Management (2005), 34, 4, 5-34.

occur,[710] giving rise to the so-called 'Agency Capitalism', defined as an "ownership structure in which agents hold shares for beneficial owners".[711] Indeed, as institutional investors are controlled by investment managers, they suffer from the agency problems deriving from the conflicts between these investment managers and their own beneficial investors. Moreover, institutional investors differ largely in terms of investment style, time horizon, size and cannot be treated as a homogeneous class.

To deal with these issues, some jurisdictions, such as the UK,[712] Japan,[713] Israel[714] and the European Union,[715] started requiring institutional investors to comply to a new set of best practices – generally under the name of 'stewardship' duties - in order to act in the interest of their beneficiaries. The term 'stewardship' refers to the "constructive shareholder engagement and monitoring of investee companies, in order to overcome the agency problems between institutional shareholders and corporate directors".[716] According to the UK Stewardship Code, stewardship activities are not limited to vote exercise, but include "monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration".[717] In line with this approach, institutional investors should also ensure that an effective leadership is established.[718]

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[710] *See* Lucian A Bebchuk, Alma Cohen& Scott Hirst, 'The Agency Problems of Institutional Investors', Journal of Economic Perspectives (2017), 31, 89-102, available at https://ssrn.com/abstract=2982617, accessed 20 December 2018.

[711] *See* Gilson & Gordon, n 704

[712] *See* FRC, 'The UK Stewardship Code' (2012), 6, available at https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf, accessed 20 December 2018.

[713] Principles for Responsible Institutional Investors ("Japan' Stewardship Code") (English translation of the revised Code), available at https://www.fsa.go.jp/en/refer/councils/stewardship/20170529.html, accessed 30 December 2018.

[714] *See* Principal Recommendations of the Committee on Enhancing Competitiveness (Isr.), available at http://www.mof.gov.il/lists/list26/attachments/291/2011-1111.pdf.

[715] Directive 2007/36/EC (recently amended in 2014 and 2017), commonly known as the "Shareholders' Rights Directive"(SRD).

[716] Chiu & Katelouzou, n 708.

[717] *See* FRC, n 712, 1. For a critical analysis of stewardship initiatives, *see* Cheffins, n 707. The author detects many deterrents to institutional shareholders' engagements, such as the comply or explain enforcement, investors' insufficient expertise, and high costs for activism.

[718] *See* FRC, n 712, 7.

The EU as well gave formal recognition to the active engagement of institutional investors in Directive 2007/36/EC – amended in 2014 and 2017 – commonly known as the "Shareholders' Rights Directive"(SRD), that encourages long-term shareholder engagement. The Directive, in particular: (a) aims at strengthening shareholders' rights and facilitating cross-border voting, (b) requires from institutional investors and asset managers more transparency in investment policies, encouraging long-term engagement, (c) requires more transparency of proxy advisors, (d) gives to shareholders a "say on pay" on directors' remuneration policy, and (e) requires more transparency and a reinforced role of shareholders in related party transaction.

However, as I have already observed, shareholder centricity might be dangerous in banking and – more in general – financial sector, as it could lead financial institutions to take high risks for profit maximization at any costs, unless some proper adjustments are made. For this reason, the SRD specifies that the "effective and sustainable shareholder engagement [...] can help improve the financial and non-financial performance of companies, including as regards environmental, social and governance factors [...].[719] To complement this framework and facilitate shareholders approach towards long-term engagement, Directive 2014/95/EU on disclosure of non-financial and diversity information requires large undertakings and public-interest entities to disclose certain information about how they operate in regular reports with reference to environmental, social and employee matters, respect of human rights, anti-corruption and bribery issues, and diversity on company boards (in terms of age, gender, educational and professional background).

The main assumption underlying these recent directives is that institutional investors may still play a beneficial role in determining corporate culture, as they can shape corporate governance, but only if they engage in the promotion of both the financial and non-financial performance of the investee companies.[720] And the current trend seems to adhere to this assumption, since a

[719] Directive (EU) 2017/828, Recital 14.

[720] The OECD itself, in 2011, highlighted the role played by institutional investors in corporate governance See OECD, The Role of Institutional Investors in Promoting Good Corporate

Eurosif Study recently found an increased engagement and voting propensity by institutional investors in 2017 compared to 2015 in the sustainable finance market.[721] Indeed, institutional investors are increasingly considering the sustainability impact produced by the firms in which they invest. Interestingly – against reasonable criticism moved in relation to the enforcement stewardship duties -[722] an empirical study conducted across 41 countries found a positive relationship between E&S performance – based on data obtained from the Thomson Reuters ASSET4 ESG database – and institutional ownership.[723] Indeed, to contribute to the establishment of a sound culture institutional investors began to push board of directors to pursue value on the long-term in combination with environmental, social and governance consideration.[724] However, this new trend will be further developed in the next Chapter in connection to the rise of sustainable finance movement.

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Governance (2011), available at http://www.oecd.org/daf/ca/corporategovernanceprinciples/49081553.pdf, accessed 30 December 2018.

[721] The survey, which covers 13 distinct markets (Austria, Belgium, Denmark, France, Germany, Italy, Netherlands, Norway, Po- land, Spain, Sweden, Switzerland, and the United Kingdom) was based on data collected from March to July 2018 from 263 asset managers and asset owners. See Eurosif, 'European 2018 SRI Study Launch' (2018).

[722] Winter, for instance, defined shareholder engagement and stewardship an "illusion", considered the structure and realities of capital markets and institutional investment (in particular, he refers to the dominant Modern Portfolio Theory, the intermediation by asset managers, the increased distance between the institutional investors and investee companies, the remuneration model for portfolio managers, the trends in solvency and accounting regulation, and the persistent pressure from the investment industry to trade shares rather than hold them). See Jaap W Winter, 'Shareholder Engagement and Stewardship: The Realities and Illusions of Institutional Share Ownership' (2011), available https://ssrn.com/abstract=1867564, accessed 30 December 2018. See also Simon C Y Wong, 'Why Stewardship is Proving Elusive for Institutional Investors', Butterworths Journal of International Banking and Financial Law (July/August 2010), 406-411.

[723] Alexander Dyck, Karl V Lins, Lukas Roth & Hannes F Wagner, 'Do Institutional Investors Drive Corporate Social Responsibility? International Evidence', Journal of Financial Economics (2018), 000, 1-22.

[724] Shareholders pressure for green resolutions is becoming the biggest challenge for oil companies such as Chevron Corp., Royal Dutch Shell, BP Plc and Exxon Mobil Corp.. See, for example, 'The elephant in the atmosphere. Managers at the biggest oil firms clash with investors over climate change' (19 July 2017), available at https://www.economist.com/business/2014/07/19/the-elephant-in-the-atmosphere, accessed 28 December 2018; Kelly Gilblom, 'BP, Shell to Face New Shareholder Challenge Over Climate in 2019' (10 Dec 2018), available at https://www.bloomberg.com/news/articles/2018-12-10/bp-shell-to-face-new-shareholder-challenge-over-climate-in-2019, accessed on 28 Dec 2018; and David French, 'Shareholders call on ExxonMobil to set greenhouse gas reduction targets' (16 Dec 2018), available at https://it.reuters.com/article/idUSKBN1OF0T8, accessed 28 Dec 2018.

# Chapter VI

## Sustainable Finance: Recent Developments and Future Prospects of a New Cultural Paradigm

2.6.1 The UN 2030 Agenda and Sustainable Development Goals, the Paris Climate Agreement and the EU Sustainable Development Strategy. – 2.6.2 The EU Action Plan for Sustainable Finance. - 2.6.3 The First (proposed) Regulatory Package on Sustainable Finance. – 2.6.4 Fostering a Sustainable Corporate Governance in EU Banks. – 2.6.4.1 The EU Approach to Sustainable Corporate Governance. – 2.6.4.2 Creating Long-Term Value with Investment: A Critical Approach.

The promotion of sustainable and long-term oriented finance is one of the core objectives to be achieved in the next two years within the CMU framework. Building sustainable finance means not only promoting green financial instruments and socially responsible investments, but implies also the integration of sound and sustainable processes and skills across the whole structure and governance of financial institutions. Consequently, I believe that it is appropriate here to provide an overview of the most recent regulatory trends in the financial sector. In fact, sustainability – a phenomenon destined to re-shape the entire EU economy – concerns the banking sector in many ways, from redesigning the composition requirements of boards, strengthening investor care and protection within the MiFID II framework, to promoting even more personalized financial products and, if well addressed, partially restoring the trust in the banking sector by making it serve directly the real economy.

This chapter starts by briefly analysing the recent developments of sustainable finance at the global level, to then give a more detailed view on the establishment of a common regime on sustainable finance in the EU, with particular reference to the Action Plan "Financing Sustainable Growth". The Action Plan, based on the recent HLEG final report, establishes a strategy for the strengthening of cooperation of the entire financial industry towards a sustainable economy. The chapter then examines the recent proposals for regulation on sustainable finance, and finally considers the consequences in terms of the corporate governance of banking institutions.

### 2.6.1 The UN 2030 Agenda and Sustainable Development Goals, the Paris Climate Agreement and EU Sustainable Development Strategy

Nowadays, sustainability is one of the most challenging global issues, affecting not only individuals but also organizations, both those operating in the financial and non-financial sector, from small & medium-sized enterprises (SMEs) to large commercial companies and governmental institutions. Climate change, wildlife extinction, poverty, illnesses and discrimination are only few of the destructive environmental and societal effects deriving from human business activities, and which have to be readdressed in order to "meet the needs of the present without compromising the ability of future generations to meet their own".[725] Accordingly, by building on the previous Millennium Declaration and Millennium Development Goals (MDGs)[726], in 2015 the UN Global Agenda 2030 set 17 sustainable goals to be reached by 2030[727], covering issues from ending poverty and hunger to ensuring access to sustainable and modern energy and clean water to all.

To combat the detrimental consequences of climate change phenomenon, in 2016, by signing the Paris agreement,[728] governments from around the world established specific environmental targets to reduce the level of green-house gas emissions released in the atmosphere and to limit global warming to well below 2°C. In the same year, the Addis Ababa Action Agenda[729] and the Sendai Framework for Disaster Risk Reduction[730] were also adopted.

Recent trends in the industrial and financial sectors reveal the renewed attention for the creation of an alternative economic system, which include the

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725 This is the first given definition of 'sustainable development', developed by the World Commission on Environment and Development (WCED), known also as the Brundtland Commission, which was established by the Secretary-General of the United Nations in December 1983. *See* World Commission on Environment and Development (WCED), 'Our Common Future', 1987.

726 UN General assembly, 'United Nations Millennium Declaration', 18 September 2000 A/RES/55/2.

727 UN General Assembly, *Transforming our world : the 2030 Agenda for Sustainable Development*, , A/RES/70/1 (21 October 2015).

728 UN, Paris Agreement on Climate Change, UN Doc. FCCC/CP/2015/L.9/Rev.1 (12 December 2015).

729 UN Resolution A/RES/69/313.

730 Adopted at the Third UN World Conference on Disaster Risk Reduction in Sendai, Japan, on March 18, 2015.

launch of sustainable financial products (such as Green Bonds, Social Bonds, Project Bonds, ESG Bonds), financial indexes (such as the Dow Jones Sustainability Indexes and the Financial Times Stock Exchange's FTSE4Good), social and environmental impact evaluation systems (such as the Global Impact Investing Rating System) and international guidelines (such as the UN Principles for Responsible Investment).

With specific reference to the financial sector, in 1992 a partnership between the United Nations Environment Programme and the global financial sector (UNEP FI) was launched with a mission to promote sustainable finance. The UNEP FI nowadays counts more than 200 financial institutions as members, committed to respecting sustainable finance principles by adhering to the backbone of the initiative, the UNEP Statement of Commitment by Financial Institutions on Sustainable Development. Subsequently, a multitude of other sustainable finance initiatives were launched or supported by UN agencies[731], or other international bodies, such as the Financial Stability Board,[732] the Global Green Finance Council (GGFC),[733] and the International Association of Insurance Supervisors (IAIS).[734] At the Paris 'One Planet Summit' in December 2017, many central banks and banking supervisory authorities gathered in the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) with the aim to promote best practices in the banking sector for the transition to a sustainable world economy.

Since the launch of the EU Sustainable Development Strategy in 2001,[735] which was revised in 2006[736] and 2009,[737] the EU Commission has made a clear

731 Such as the 2006 Principles for Responsible Investment, the 2012 Principles for Sustainable Insurance and the 2017 Principles for Positive Impact Finance.

732 In particular, the FSB in 2015 established the Task Force on Climate-related Financial Disclosures, which published its final recommendations in June 2017. See https://www.fsb-tcfd.org/publications/final-recommendations-report/, accessed 28 December 2018.

733 The GGFC was established in 2017 and in March 2018 it supported the Loan Market Association (LMA) in the publication of the 'LMA Green Loan Principles', available at https://www.lma.eu.com/news-publications/press-releases?id=146, accessed 28 December 2018.

734 This has recently held a consultation on an issues paper on climate change risk for the insurance sector. Available at www.iaisweb.org, accessed 3 January 2018.

735 European Commission, Communication from the Commission A Sustainable Europe for a Better World: A European Union Strategy for Sustainable Development, COM/2001/0264 final.

736 European Council DOC 10917/06.

737 European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions -

commitment to contribute to promoting sustainable development in key cross-sectorial projects, by intervening in all environmental, social and governance (ESG) areas. The introduction of the Europe 2020 Strategy in 2010[738] and the explicit link made to the UN Sustainable Development Goals in the 2016 Commission Communication on the next steps for a sustainable European future[739] confirmed the EU's role as frontrunner in the implementation of the UN Agenda.

### 2.6.2 The EU Action Plan for Sustainable Finance

Financial institutions, as key providers of funding, play a major role in the transition to a new sustainable and circular economy. As also highlighted by the EU Commission in the Action Plan, "Financing Sustainable Growth" published in March 2018,[740] change is possible only by reorienting private capital to more sustainable investments. In fact, it was estimated that more capital flows should be oriented towards sustainable investments to close the €180-billion gap of additional investments needed to meet the EU's 2010 targets of the Paris Agreement.

As a consequence, at the end of 2016, the EU Commission appointed a High-Level Expert Group (HLEG) on sustainable finance to advice it on developing a comprehensive EU strategy on sustainable finance and development. The HLEG final report,[741] issued in January 2018, stresses the importance to promote sustainable finance through a systemic review of the

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Mainstreaming sustainable development into EU policies: 2009 Review of the European Union Strategy for Sustainable Development, COM(2009) 400 final.

738 EU Commission, Europe 2020: A strategy for smart, sustainable and inclusive growth, COM(2010) 2020 final.

739 EU Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Next steps for a sustainable European future European action for sustainability, COM(2016) 739 final.

740 EU Commission, Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Wconomic and Social Committee and the Committee of the Regions, Action Plan: Financing Sustainable Growth, COM(2018) 97 final (March 2018).

741 HLEG, 'Final Report', 2018, available at https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf, accessed on 3 October 2018.

financial framework, and proposes eight recommendations,[742] as well as crosscutting recommendations and actions addressed to specific financial sectors.

In March 2018, on the basis of the Final Report published by the HLEG, the Commission adopted the Action Plan, "Financing Sustainable Growth" ('Action Plan'),[743] which establishes a strategy for enhancing the connection between the financial industry and sustainable development. The Action Plan specifically pursues three objectives: (i) reorienting capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth; (ii) managing financial risks stemming from climate change, environmental degradation and social issues; and (iii) fostering transparency and long-termism in financial and economic activity. The EU strategy specifically develops around ten key actions to be fully implemented by the end of 2019, and which are: (a) establishing an EU classification system for sustainable activities; (b) creating standards and labels for green financial products; (c) fostering investment in sustainable projects; (d) incorporating sustainability when providing financial advice; (e) developing sustainability benchmarks; (f) better integrating sustainability in ratings and market research; (g) clarifying institutional investors' and asset managers' duties; (h) incorporating sustainability in prudential requirements; (i) strengthening sustainability disclosure and accounting rule-making; and (l) fostering sustainable corporate governance and attenuating short-termism in capital markets.

### 2.6.3 The First (proposed) Regulatory Package On Sustainable Finance

The EU Commission has already taken concrete steps in the enactment of the Action Plan, and in May 2018 it adopted a package of measures, which

742 The recommendations are: (i) establishing a common sustainable finance taxonomy; (ii) clarifying investor duties to extend time horizons and bring greater focus on ESG factors; (iii) upgrading EU disclosure rules, especially in relation to climate change; (iv) improving citizens' access to information on sustainability performance and promoting financial literacy; (v) developing EU sustainable finance standards, starting with one on green bonds; (vi) establishing a 'Sustainable Infrastructure Europe' facility to expand the size and quality of the EU pipeline of sustainable assets; (vii) reform governance and leadership of companies in order to integrate sustainable finance competencies; and (viii) enlarging the role and capabilities of the ESAs to promote sustainable finance as part of their mandates.

743 EU Commission, n 740.

include: (i) the Regulation on the establishment of a framework to facilitate sustainable investment;[744] (ii) the Regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive EU 2016/2341 ('IORP II');[745] (iii) the Regulation amending Regulation EU 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks[746]. Moreover, in order to ensure that investors' sustainability preferences are taken into account in the suitability assessment, the Commission proposed to amend delegated acts under MiFID II and IDD (with respect to investment-based insurance products).[747]

(i) Regulation on the establishment of a framework to facilitate sustainable investment

The first proposal for regulation[748] specifically addresses both the first recommendation by the HLEG and the first key action listed in the Action Plan aiming at gradually establishing a unified EU classification system to determine which economic activities are considered sustainable, and then to provide unified standards, labels and sustainability benchmarks based on the same. Setting out a clear taxonomy for sustainable finance is by no means the most urgent need for a successful implementation of the entire Action Plan, as the different labels and interpretations given by each Member State as to what can be defined sustainable undoubtedly discourage investors from investing by making comparison too expensive and raising the risk of greenwashing practices.[749]

744 Proposal for a regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment, COM(2018)353/978670.
745 Proposal for a regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341, COM(2018)354/978576.
746 Proposal for a regulation - COM(2018)355/978587.
747 Commission Delegated Regulation (EU) …/.. of XXX, amending Delegated Regulation (EU) 2017/2359 with regard to environmental, social and governance preferences in the distribution of insurance-based investment products, Ref. Ares(2018)2681527 - 24/05/2018, and Commission Delegated Regulation (EU) …/... of XXX amending Regulation (EU) 2017/565 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, Ref. Ares(2018)2681500 - 24/05/2018.
748 Proposal for a regulation, n 744.
749 Id., Explanatory Memorandum, 1,2.

The proposal establishes uniform criteria for determining whether an economic activity is environmentally sustainable, and it further sets out a process involving a multi-stakeholder platform to establish a unified EU classification system based on a set of specific criteria.[750] However, it does not establish a label for sustainable financial products, but it only sets out the criteria to be taken into account when setting up sustainability labels at national or EU level. The specific uniform technical criteria will be developed at Level 2 in delegated acts.[751] To this end, in July 2018, the EU Commission set up a Technical Expert Group on Sustainable Finance (TEG) to assist it in further developing an EU classification system.

The proposal, though specifically addressing only environmentally sustainable investments, also provides for a review clause to possibly extend the scope of the regulation to include social objectives,[752] as the urgency to act against climate change and meet energy targets convinced the EU Commission to address social sustainability in a second phase.[753]

(ii) Regulation on disclosures relating to sustainable investments and sustainability risks

The second proposal for regulation[754] aims to increase transparency on the integration of ESG risks in investment decision-making and advisory processes, therefore responding to both the seventh - concerning the clarification of institutional investor's and asset manager's duties – and the eighth concrete action included in the Action Plan concerning disclosure of information in relation to ESG factors.

The regulation is addressed to financial market participants – insurance undertakings, managers of venture capital funds and social entrepreneurship funds, and UCITS – and investment firms. The regulation requires them to properly disclose how they consider ESG risks in their decision-making and

750 *Id.*, Explanatory Memorandum, 1.
751 *Id.*, Explanatory Memorandum, 11.
752 *Id.*, Article 17.
753 EU Commission, n 740, 11-12.
754 Proposal for a regulation, n 745.

advisory processes. Imposing consistent disclosure criteria is deemed necessary since 'divergent disclosure standards and market-based practices make it very difficult to compare different financial products and services, create unfair conditions for different financial products and services, manufacturers and distribution channels, and erect additional barriers to the internal market'.[755] However, more detailed requirements will be further specified through Delegated Acts, which will be adopted by the Commission at a later stage.

Even though the integration of ESG factors by institutional investors and asset managers is deemed rather weak,[756] the feedback statement accompanying the proposal suggests that an increasing majority of respondents already take into account sustainability factors in their investment decision-making,[757] as also highlighted in other recent surveys.[758] In fact, a number of studies show how traditional investment strategies do not outperform socially responsible investment ones,[759] but sometimes even underperform them;[760] a cautious optimism however is suggested with respect to social value creation.[761]

Even though I cannot fully analyse the content of the proposal here, an objection must be raised with reference to the given definition of 'sustainable

755 Proposal for a regulation, n 745, Explanatory Memorandum, 5.
756 Proposal for a regulation, n 745, Explanatory Memorandum, 7.
757 Feedback Statement, Public Consultation on Institutional Investors' and Asset Managers' Duties regarding Sustainability page 23, https://ec.europa.eu/info/files/2017-investors-duties-sustainability-feedback-statement_en, May 24, 2018.
758 EY Climate Change and Sustainability Services (CCaSS), 'Is your nonfinancial performance revealing the true value of your business to investors?' (2017); CFA Institute, 'Environmental, Social and Governance (ESG) Survey', 2017.
759 Gunnar Friede, Timo Busch & Alexander Bassen, 'ESG and financial performance: aggregated evidence from more than 2000 empirical studies', Journal of Sustainable Finance & Investment (2015), 5, 4, 210-233; Morgan Stanley, Institute for Sustainable Investing, Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies (Mar. 2015), available at https://www.morganstanley.com/sustainableinvesting/pdf/sustainable-reality.pdf, accessed 3 January 2018; Lloyd Kurtz & Dan di Bartolomeo, 'The Long-Term Performance of a Social Investment Universe', J. INVESTING (2011) 95, 100; Timo Busch, Rob Bauer & Marc Orlitzky, 'Sustainable Development and Financial Markets', Business & Society (2016), 55, 3, 303-329.
760 Mozaffar Khan, George Serafeim & Aaron Yoon, 'Corporate Sustainability: First Evidence on Materiality', The Accounting Review (2016), 91, 6, 1697-1724, available at https://ssrn.com/abstract=2575912, accessed 30 December 2018.
761 Paul Brest, Ronald J Gilson & Mark A Wolfson, 'How Investors Can (and Can't) Create Social Value', European Corporate Governance Institute (ECGI) - Law Working Paper No. 394/2018; Columbia Law and Economics Working Paper No. 583; Stanford Law and Economics Olin Working Paper No. 520; Stanford University Graduate School of Business Research Paper No. 18-23.

investment'. The proposal defines 'sustainable investments' as "any of the following or a combination of any of the following: (i) investments in an economic activity that contributes to an environmental objective [...]; (ii) investments in an economic activity that contributes to a social objective [...]; (iii) investments in companies following good governance practices [...]".[762] However, I find this definition troublesome since it seems too broad and risks not to functionally help identify sustainable investment – in terms of ESG criteria. Defining 'sustainable' those investments made only by considering the performance of one or two of the three ESG aspects, at the cost of the other one or two, seems to be in stark contradiction to the definition of 'sustainable investment' itself, since all three pillars (economy, society and environment) are necessary for the stability of the system.

If we especially consider the recent scandals involving companies – such as Wells Fargo – with 'good governance' in place, we easily conclude that defining 'sustainable companies' those with only good governance performance appears senseless. This definition could have sounded more reasonable only in the event governance requirements for business activities took into account social and environmental issues, which means, however, that current corporate governance standards should be totally revised or, at least, some "sustainable corporate governance standards" should be established first.

(iii) Regulation on low carbon benchmarks and positive carbon impact benchmarks

The third regulation[763] aims at introducing rules establishing and governing the provision of low carbon and positive carbon impact benchmarks, consistent with the fifth action included in the Action Plan. Stakeholder consultation revealed that most institutional investors do not use a low-carbon index because: (i) current methodologies do not reflect all sources of carbon emissions; (ii) their clients (investors) have no confidence in the methodology

762 Proposal for a regulation, n 745, Article 2(o).
763 Proposal for a regulation, n 746.

employed by available low-carbon indices; and (iii) there is an absence of low-carbon indices that reflect their investment approach and style.[764]

In contrast to initial aims, the new framework will not introduce a fully harmonized regime for the methodology of the new benchmarks categories on the basis of a comprehensive set of rules, but rather will provide for the imposition of minimum standards for low-carbon and positive carbon impact benchmarks.

### 2.6.4 Fostering Sustainable Corporate Governance in Banks

#### 2.6.4.1 The EU Approach to Sustainable Corporate Governance

The tenth and final concrete action included in the Action Plan concerns the fostering of sustainable corporate governance and attenuating short-termism in capital markets. In other words, in order to promote sustainable finance, according to the EU Commission, banks should establish a sort of 'sustainable board' and 'sustainable processes'.

The Commission argues that corporate governance "can significantly contribute to a more sustainable economy, allowing companies to take the strategic steps necessary to develop new technologies, to strengthen business models and to improve performance", but also "improve their risk management practices and competitiveness".[765] However, corporate governance excessively focused on short-term performance may lead managers to take risks that are unsustainable in the long-term.

In this regard, the HLEG Report suggests: (i) updating the fit and proper tests; (ii) extending the Stewardship Principles for institutional investors, as well as (iii) strengthening director duties related to sustainability. In relation to the first suggestion, the HLEG recommends that fit and proper tests should include an assessment of the individual and collective ability of the members of boards

764 Proposal for a regulation, n 746, Explanatory Memorandum, 6.
765 EU Commission, n 740, 11.

"to address sustainability risks, to understand the broader stakeholder context and to take into account client's sustainability preferences".[766] Both ECB [767]' and ESMA and EBA Guidelines[768] should be therefore revised in order to integrate new requirements in terms of skills, competence and experience by board members required for the evaluation of sustainability risks.

Moreover, the EBA Guidance[769] should be emended in order to clarify that 'risk strategy' under article 88 of the CRD includes long-term risks including sustainability risks.

With reference to the second suggestion, the HLEG recognized the key role of institutional investors in the promotion of sustainable finance.[770] ESG and long-term investing, as well as active engagement – consistent with the ICGN Global Stewardship Principles[771]– should be concretely fostered in the EU legislative framework by means of an amendment of the Shareholder Rights Directive.[772] New requirements should be inspired by the six Principles for Responsible Investment (PRI),[773] according to which institutional investors assure to: (i) incorporate ESG issues into investment analysis and decision-making processes; (ii) be active owners and incorporate ESG issues into ownership policies and practices; (iii) seek appropriate disclosure on ESG issues by the entities in which they invest; (iv) promote acceptance and implementation of the Principles within the investment industry; (v) work together to enhance the effectiveness in implementing the Principles; and (vi) report on activities and progress towards implementing the Principles.

In relation to the last suggestion, the report invites the Commission to explore ways to enhance director duties and incorporate sustainability in corporate practice, by taking into account the interests of all stakeholders,

766 See n 56, 39.
767 ECB, n 99.
768 ESMA and EBA, n 100.
769 EBA, n 137.
770 See n 56, 40, 41.
771 *See* International Corporate Governance Network, 'ICGN Global Stewardship Principles', 2016. In particular, Principle 6 states that "Investors should promote the long-tem performance and sustainable success of companies and should integrate material environmental, social and governance (ESG) factors in stewardship activities".
772 *See* Directive 2017/828 amending Shareholders' Rights Directive.
773 These were issued in 2006 by a UN-supported international network of investors, in partnership with UNEP Finance Initiative and the UN Global Compact.

employees included, and the likely consequences of any decision in the long term (which means beyond three or five years) on the community and environment. The HLEG Report also suggests that boards should verify the integrity of the most significant business partners in the company's supply chain.[774] Directors should be adequately trained in order to exercise reasonable care, skill and due diligence in relation to the company's affairs, including the direct and indirect impact of the company's business model, production and sales processes on stakeholders and the environment. Board nomination processes should consider also competence in material sustainability matters, and regular reporting about sustainability strategy should be carried out. Moreover, company management should develop a climate strategy aligned with climate goals, and remuneration should be aligned with long-term and sustainability goals.

This recommendation seems to give a definitive answer to the concerns that arose in the 1990s as to the infringement of breach of the duty of loyalty by institutional investors who practice socially responsible investing (SRI)[775]or the most recent ESG investing.[776] In fact, some commentators have considered inconsistent with the duty of loyalty any investment activity that entails the sacrifice of the interests of beneficiaries in favour of social causes.[777] On the contrary, on the basis of the HLEG recommendations, integrating ESG risks into investment strategies has become a fiduciary duty.

Interestingly, the EU strategy for corporate governance partially follows

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774 *See* n 56, 41.

775 Socially responsible investing (SRI) emerged as a new institutionalized investment strategy in the 1960s, and at the beginning identified a negative screening investment strategy for the promotion of ethical values, with no consideration of investment returns. In 1970s with the Pax World Fund - the first ethical mutual fund - and the "Sullivan Principles", the new ethical movement gained global importance. Only in the late 1980s the concept developed into other modern forms, as investment strategies both employing negative and positive screening techniques to maximize financial return with an attention to ethical values. *See* Russell Sparkes & Christopher J Cowton, 'The maturing of Socially Responsible Investment: A Review of The Developing Link With Corporate Social Responsibility', Journal of Business Ethics (2004), 52, 45-57.

776 This can be defined as the investment strategy that integrate material environmental, social and governance (ESG) factors into traditional financial metrics, in order to identify both opportunities and risks. Contrary to SRI, ESG investing does not imply negative screening and includes ESG factors to identify companies with higher investment potential on the long-term. *See* Lauren Caplan, John S Griswold & Jarvis F Williams, 'From SRI to ESG: The Changing World of Responsible Investing', Commonfund Institute (2013).

777 Uniform Prudent Investor Act, Par. 5 cmt. (1994).

the HLEG recommendations, as it seems to prefer a more cautious path by only planning, by mid-2019, to carry out analytical and consultative work with relevant stakeholders to assess: (1) the possible need to require corporate boards to develop and disclose a sustainability strategy, including appropriate due diligence throughout the supply chain, and measurable sustainability targets; and (2) the possible need to clarify the rules according to which directors are expected to act in the company's long-term interest.[778] The Commission invites the ESAs to collect evidence of undue short-term pressure from capital markets on corporations and consider, if necessary, further steps based on such evidence by March 2019. More specifically, the Commission invites ESMA to collect information on undue short-termism in capital markets, including: (1) portfolio turnover and equity holding periods by asset managers; (2) whether there are any practices in capital markets that generate undue short-term pressure in the real economy.[779] No direct intervention on corporate governance is therefore provided in the Action Plan, which can be explained by the necessity to first respond to the most urgent actions – such as establishing a EU taxonomy and harmonizing low-carbon benchmarks.

However, as culture and behaviour is the direct expression of short-term and long-term orientation, these aspects should not be overlooked. An integrated social-ecological system perspective is the only reasonable response to the dynamic and interlinked environmental, societal and economic challenges.[780]

#### 2.6.4.2 Creating Long-term Value with Investment: A Critical Approach

The concept of responsible investing, which is nowadays spreading throughout the entire financial sector as the new frontier of investment strategy,[781] has its roots in the stakeholder theory introduced in the 1980s,[782] or

778 European Commission, n 740, 11.
779 *Ibid.*
780 Albert V Norströmet al., 'Three necessary conditions for establishing effective Sustainable Development Goals in the Anthropocene', Ecology and Society (2014), 19, 3, 8.
781 Evidence suggests that the market share of sustainable investments has been growing in recent years. *See* Eurosif, n 721.

better in the so-called "enlightened shareholder theory" of corporate governance created by Jensen in the early 2000s.[783] According to Jensen's model, shareholders primacy and stakeholder theory are not systematically incompatible, since in his view "we cannot maximize the long-term market value of an organization if we ignore or mistreat any important constituency" and, in particular, "we cannot create value without good relations with customers, employees, financial backers, suppliers, regulators and communities".[784] More recently, the concept has developed into the new notion of long-term value creation involving the aim of a company "to optimise its financial, social and environmental value in the long term",[785] as well as to pursue not only shareholder value but instead shareholder welfare, which means that shareholders should internalize the externalities that usually stakeholders have to hold.[786] This definition seems to integrate the concept of long-term value focused on firms' stakeholders with the definition of sustainable development given in the Brundtland report (see 1.4.1), which highlights the importance of the impact of business operations not only on the direct stakeholders, but on society and environment at large, so putting into question the role of corporations in society and enlarging their liability. Interestingly, following this line, a legislative proposal has been made in France to amend the civil code in order to reinforce the consideration of social and environmental issues in the strategy and operations of companies, which means that directors and boards

782 Edward Freeman introduced the concept of stakeholder theory. He notoriously argues that managers bear a fiduciary relationship to stakeholders (specifically suppliers, customers, employees, stockholders, and the local community, since "each of these stakeholder groups has a right not to be treated as a means to some end, and therefore must participate in determining the future direction of the firm in which they have a stake". *See* Freeman, n 10.

783 This theory (Jensen, n 305, 8-21.) is the clear response to the criticism moved against traditional stakeholder theory, where directors are asked to serve simultaneusly two masters, posing a serious agency problem (*see* Frank H Easterbrook & Daniel R Fischel, *The Economic Structure of Corporate Law*, Harvard University Press, 199, 38.

784 Jensen, n 305, 16.

785 Schoenmaker & Schramade, n 306. See also Dyllick and Muff, n 306; Tirole, n 306; and Schoenmaker, n 306.

786 Hart & Zingales, n 307.

would have to integrate sustainability considerations in all decision-making processes.[787]

This theoretical model recently extended to financial operations, and now institutional investors are increasingly required to engage actively in promoting ESG-aligned businesses.

To do that – regardless of the reasons justifying the trend –[788] they have to rely on specific ESG data and ratings providers for the measurement and assessment of companies' ESG performance. However, the lack of reliable information concerning companies' ESG performance makes it difficult for professional investors to identify in which companies they should invest in order to promote a sustainable economy. A recent study by Busch et al. even claims that though sustainable concerns are integrated in investment processes, the shift towards more sustainable business seems rather weak, or at least has failed to effectively produce beneficial effects on the environment and society.[789] The authors claim that a major cause for this failure is the lack of trustworthy ESG data and clarity regarding how such data are taken into account in investment policies.

Schoenmaker and Schramade identified four main reasons why ESG are not fully reliable.[790] First, ratings have little focus on material issues, and negative material issues can be easily cancelled by positive non-material ones. Second, the nature of most of the information on which they are built is

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787 '*Project De Loi relatif à la croissance et la transformation des entreprises*', Article 61. Available at https://www.actu-environnement.com/media/pdf/news-31994-projet-loi-pacte-gouvernement.pdf, accessed 5 November 2018.

788 Bénabou and Tirole hypotisize three conceptual views leading to individuals and firms to sustainability concerns: (i) the 'win-win' view ('being a good corporate citizen can also make a firm more profitable'; (ii) the 'delegated philanthropy' (the firm as a channel for the expression of citizen values (the company/investor acts as a channel for the expression of citizen values), and (iii) the 'insider initiated philanthropy' (the inclusion of sustainability consideration reflects the management's or the board members' own values). *See* Roland Bénabou & Jean Tirole, 'Individual and corporate social responsibility', Economica (2010), 77, 305, 1-19. Gibson and Krueger applied the framework to institutional investors. *See* Rajna Gibson Philipp Krueger, 'The Sustainability Footprint of Institutional Investors', Swiss Finance Institute Research Paper No. 17-05; European Corporate Governance Institute (ECGI) - Finance Working Paper No. 571/2018, available at https://ssrn.com/abstract=2918926 or http://dx.doi.org/10.2139/ssrn.2918926, accessed 30 December 2018.

789 Busch, Bauer &Orlitzky, n 759, 303-329.

790 Schoenmaker, n 306; and Schoenmaker & Schramade, n 306.

voluntarily-based and hard to verify, and this also tends to favour only large companies that can afford to spend substantial amounts of money for sustainability communication. Third, scores are usually focused on operations instead of the products of the companies, and this leads to the absurd result of awarding unsustainable businesses in, for example, the coal and tobacco industries. Fourth, in-depth assessment is excluded by the fact that each analyst should cover about 70 stocks at the same time.

Moreover, the results of studies investigating the link between ESG and performance are mixed, and differ in respect to the different models of sustainable investment strategy implied.[791] As for Socially Responsible Investment (SRI) funds, studies found that, in comparison with non-SRI funds, their performance generally does not substantially differ,[792] and sometimes shows better results.[793] However, some SRI funds mainly focused on negative screening - and therefore passively managed – show negative results compared to non-SRI funds,[794] suggesting that more actively-managed SRI funds – focused on best-in-class selection processes –generally perform better than those passively managed.[795] As for specific ESG investing, some studies have shown that ESG based investments – which are actively managed – perform as well as[796] or better than non-sustainable investment strategies.[797] As for impact

791 Susan N Gary, 'Best Interests in the Long Term: Fiduciary Duties and ESG Integration' University of Colorado Law Review (2018), 90, available at https://ssrn.com/abstract=3149856 or http://dx.doi.org/10.2139/ssrn.3149856, accessed 30 November 2018.

792 Luc Renneboog, JenkeTer Horst & Chendi Zhang, 'The price of ethics and stakeholder governance: The performance of socially responsible mutual funds', Journal of Corporate Finance (2008), 14, 3, 302-322; Jeroen Derwall Kees Koedijk, 'Socially responsible fixed-income funds', Journal of Business Finance and Accounting (2009), 36, 1–2, 210–229; Meir Statman, 'Socially responsible indexes', Journal of Portfolio Management (2006), 32, 3, 100–109; Christophe Revelli Jean‐Laurent Viviani & Revelli, 'Financial performance of socially responsible investing (SRI): What have we learned? A meta-analysis', Business Ethics: A European Review (2014), 24, 2, 158–185.

793 *See* Deutsche Bank Group, 'Sustainable Investing/Establishing Long-Term Value and Performance', 2012; David M Blanchett, 'Exploring the Cost of Investing in Socially Responsible Mutual Funds: An Empirical Study', Journal of investing (2010), 19: 102.

794 The Asset Management Working Group Of The United National Environment Programme Finance Initiative And Mercer, 'Demystifying Responsible Investment Performance', (2007), available at http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf, accessed 6 January 2018.

795 Blanchett, n 793.

796 Friede, Busch & Bassen, n 259.

investment,[798] a study by Cambridge Associates and the Global Impact Investing Network showed that, by analysing the data collected by the Impact Investing Benchmark created by the same, impact investments did not underperform their (non impact investment-based) competitors, except for the impact investments launched in recent years, which is easily understandable given that impact investments usually grant financial returns in the long term.[799]

The idea of using only traditional quantitative methods implied in passive investing to investigate qualitative issues poses many limitations. The authors suggest a new investment paradigm that involves an increase in active engagement with investee companies, and therefore one that requires investors to manage more concentrated portfolios,[800] in order to get a more exhaustive view of the actual integration of a sound and sustainable culture in the firm.[801] This is in direct opposition to the Modern Portfolio Theory, currently the most popular model at the base of investment strategies, which suggests high diversification as well as passive investment strategies.[802] The authors also suggest that investment chains should be shorter and simpler, since much of the relevant information tends to be lost during the investment chain process.

As we have seen, an increasing number of academics and financial associations strive to measure the financial performance of sustainable and responsible investment strategies in comparison with traditional ones. However, they all seem to ignore crucially the non-financial return on the investment (by

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797 *See* e.g. Alez Edmans, 'Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices, Journal of Financial Economics (2011).

798 Impact investments have been defined as the "investments made into companies, organizations, and funds with the intention to generate a measurable social and environmental impact alongside a financial return". See https://thegiin.org/impact-investing/need-to-know/#s7.

799 Cambridge Associates & GIIN, 'Introducing the Impact Investing Benchmark', available at https://thegiin.org/assets/documents/pub/Introducing_the_Impact_Investing_Benchmark.pdf.

800 The idea of less diversified portfolios is shared also by Warren Buffet who stated that "....If you are a know-something investor, able to understand business economics and to find five to ten sensibly-priced companies that possess important long-term competitive advantages, conventional diversification makes no sense for you. It is apt simply to hurt your results and increase your risk". Buffet then quotes Keynes, who said that: "As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes". *See* Warren Buffett, *The Essays of Warren Buffett*, edited by Lawrence A. Cunningham, 2009, 99, 104.

801 Schoenmaker, n 306; Schoenmaker & Schramade, n 306.

802 Harry Markowitz, 'Portfolio Selection', Journal of Finance (1952), 77, 7.

applying, for example, social return on the investment, SROI), represented by the positive social or environmental impact produced by the investment. Since sustainable finance, especially impact investment, aims at both financial and non-financial returns, they should be both taken into consideration in their evaluation, especially with reference to impact investments. However, the systems to measure the social and environmental impact produced by such investments are so far not fully developed and harmonized, and therefore they are not completely reliable. As a consequence, I argue that instead of continuing to carry out studies to compare the financial performance of sustainable and non-sustainable investments, efforts should be better focused on the development of consistent systems to measure the SROI in impact investments. As for SRI and ESG investment strategies, since these do not provide specific expectations of social and environmental impacts, new methodologies should be put in place that reflect the way ESG criteria have been integrated in the decision-making.

In the light of the above considerations, we can easily understand why the EU reforming proposals, though admirable, risk oversimplifying a complex issue that cannot be easily solved solely by establishing better disclosure or the harmonization of ESG taxonomy and benchmarks. These are undoubtedly the most direct responses to urgent issues such as climate change, and will lay the foundation for the next steps of sustainable economic transition. However, time is required to make the new apparatus work, and to spread the new sustainability principles so that they become common values. Moreover, all pro-ESG initiatives seem to be carried out without taking a clear position on the role companies should play, or at least without distinguishing where the role of corporations should end and the role of governments should start. Recognising the social and environmental liabilities of corporations should not be a justification for national governments not to exercise their political powers to enhance the economic transition towards a more sustainable system based on the principles of comprehensiveness, connectivity, equity, prudence and security.[803] The fact that product demand ultimately derives from societal needs – which is

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803 These five principles were defined by Thomas N Gladwin, James J Kennelly & Tara-Shelomith Krause, 'Shifting paradigms for sustainable development: Implications for management theory and research', Academy of Management Review (1995), 20, 4, 874-907.

the main justification moved by Friedman for companies not to take care of sustainability – makes both national governments and corporations - which nowadays are partially creating the demand themselves – responsible for a change in production-consumption philosophy. If capitalism has to stay, it requires a profound cultural reshaping to make real change achievable.

## Conclusion

In this thesis, I did not limit my analysis to the recent reforms that reshaped the corporate governance of banks, but I also investigated several cultural aspects that structure behaviour and character in financial institutions, and reinterpreted governance mechanisms in the light of psychological and sociological studies. The main assumption on which the thesis is based is that inadequate rules, bad corporate governance and lack of public enforcement cannot fully explain the widespread malpractice in the financial sector. The nature of the determinants of misconduct is behavioural and cultural, and given that regulation *per se* cannot be expected to promote good corporate culture, I argue that the role of corporate governance should be enhanced so as to reinforce sustainable conduct within financial institutions. However, following the traditional lawyerly approach to corporate governance based on the standards and procedures described in the previous chapters may not be sufficient, while the risk of adding costs and bureaucracy within financial institutions is high. Governance models should be instead analysed with a focus on the organizational and cultural aspects of institutions. Scholars in this area should therefore undertake in-depth studies on the determinants of human behaviour, the relevant processes, and the motivations leading people to act the way they do.

Moreover, I argue that in order to change culture – due to its multi-layered nature - a combination of practical values, norms, and formal institutions is required. As explained in the previous sections, the board is key to developing an organizational structure based on ethical values which should shape every decision-making process, guide managers and employees to behave with integrity, and, to a certain extent, take into consideration stakeholders' interests (in order to prevent substantial costs of future litigation).

However, the organizational framework may prove effective only when it is set in a good institutional framework. Supervisory authorities, firm's shareholders — in particular, institutional investors — and the entire financial community should support the board in this new path for sustainable development and finance. Indeed, external pressure by revealing the benefits of

ethicality and sustainability can incentivize a long-term view in managing the firm.

To conclude, without entirely rejecting the idea of financial capitalism, this thesis claims that finance should be a functional science that exists to support the goal of constructing a good society.[804] For this to be achieved, a new path needs to be taken towards an evolution in terms of "democratizing and humanizing and expanding the scope of financial capitalism"[805] and, therefore, to further study what factors induce financial operators to crime and misbehaviour and what is needed to reshape their values and character in order to build a harmonious society.

[804] Robert Shiller, *Finance and the Good Society*, Princeton University Press, 2012, 5–9.
[805] *Ibid.*

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