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PEGASUS

A NEWSLETTER FOR THE CAUX ROUND TABLE FOR MORAL CAPITALISM NETWORK LOOKING AT BUSINESS ABOVE THE CLUTTER AND CONFETTI

Pegasus

Introduction

In their massively detailed book, Why Nations Fail, co-authors Daron Acemoglu and James A. Robinson, examine all the theories – cultural, religious, ethnic, geographic, climatological and more – and conclude that none of these factors, in and of themselves, can explain why some nations struggle along as near failed states, while others, like the U.S. and most nations of Northern Europe, prosper.

The underlying cause of the disparity, the authors argue, is institutional. Prosperous countries have political and economic institutions designed to keep a country on an even keel, more or less, with a fair sharing of wealth and hardships. In other countries, not so much. In those nations, institutions are designed, however much a constitution or statutes aim to curb inequality, to expropriate wealth from below and turn it over to the rich and powerful to do with it as they will.

The U.S. is far from what anyone might define as a failed state but there are worrisome signs. Beginning in the 1970s in response to growing international competition, restrictions on the financial sector – a critical component of a successful capitalist economy – have led to what some call the "financialization" of America. As the decades have worn on – and in particular with the sweeping deregulation of the late 1990s – disparities grew ever wider, leading directly to the speculative lunacy of the 2008 market crash. Today, middle class incomes have stagnated, the amount of wealth is concentrated into fewer and fewer hands and even now, more than 10 years after the economic collapse, we still don't seem to have figured out exactly how to alter the regulatory landscape in a way that will push the U.S. back toward historical norms of relative equality and shared prosperity.

In recent years, a growing percentage of the populace has begun to despair that we can get back on the right track. Polls show that socialism, the bête noire of a country that equates capitalism with freedom, has found favor among a growing percentage of the public, particularly the young. Today, many Americans see their political and economic institutions as designed to serve the wealthy and powerful and to leave the rest of us to struggle along as best we can.

In this issue, we take a look at financialization in the U.S. and Europe, how we got here, what can be done to change the scheme of things, and where we must go to regain our status as a fully robust, successful nation.

We include in this issue: 1) a comment on financialism, as reflected in the views of some of our participants; 2) an interview with Cosima Barone of the Convention of Independent Financial Advisors in Geneva; 3) a code of conduct for banks and financial institutions drafted by us at the request of John C. Whitehead, former Co-Chairman of Goldman Sachs; 4) an interview with Henry Engler of Thomson Reuters by Brian Gallagher of Ethical Systems; and 5) a summary by Stephen B. Young, our Global Executive Director.

Richard Broderick
Director of External Affairs
Caux Round Table for Moral Capitalism

Our New Stage of Capitalism – Financialism

by Richard Broderick

Here at the offices of the Caux Round Table for Moral Capitalism (CRT), we have a little joke that's been circulating now for several months. The CRT, as you know, has as its objective the promotion of a "moral capitalism" rooted in principles of ethics, fairness and concern for all of a business' constituencies, from shareholders to employees, to local residents to the environment. But now, we sometimes wonder if it is really textbook capitalism that, more or less, rules the global economy. Or, in fairness, should we now be speaking of "financialism" as the dominant rubric of today's capitalism?

Financialism is a reference to the financialization that has taken place in money centers around the world. The financialization of the American economy over the past 40 years has reached breathtaking heights. The lasting effects of that takeover is growing income inequality, as the middle class bumps along with very little increase in salaries and income, while the top 10 percent continues to enjoy a growing share of the nation's wealth.

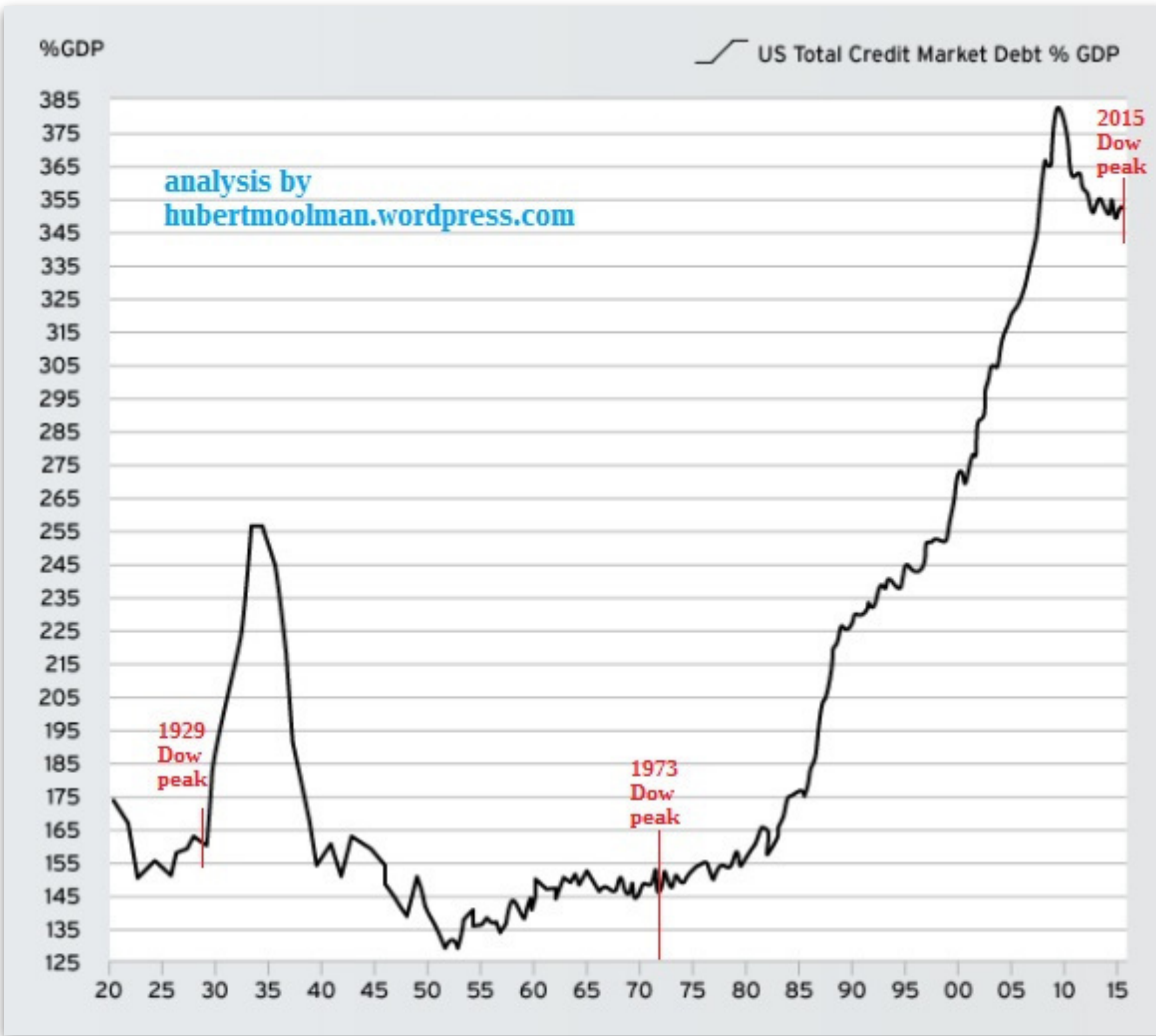
The financial sector, of course, has been a critical component of capitalism since its origins in the late 17th and early 18th centuries. In fact, without a financial sector, there would be no such thing as capitalism because it is the financial sector whose role has been to provide the money to underwrite the creation of facilities that produced goods and services, such as factories, warehouses, transportation systems, distribution systems and the like.

Until the mid-1970s, the financial sector played precisely this role in the American economy, governed by rules and regulations, some of them, like the Glass Steagall Act, passed in the wake of the speculation-fueled collapse of the Stock Market in 1929, which said that banks could either fund commerce – holding depositors' money and investing it in productive enterprises – or investment for their own account earning a higher rate of return but at a greater risk of loss.

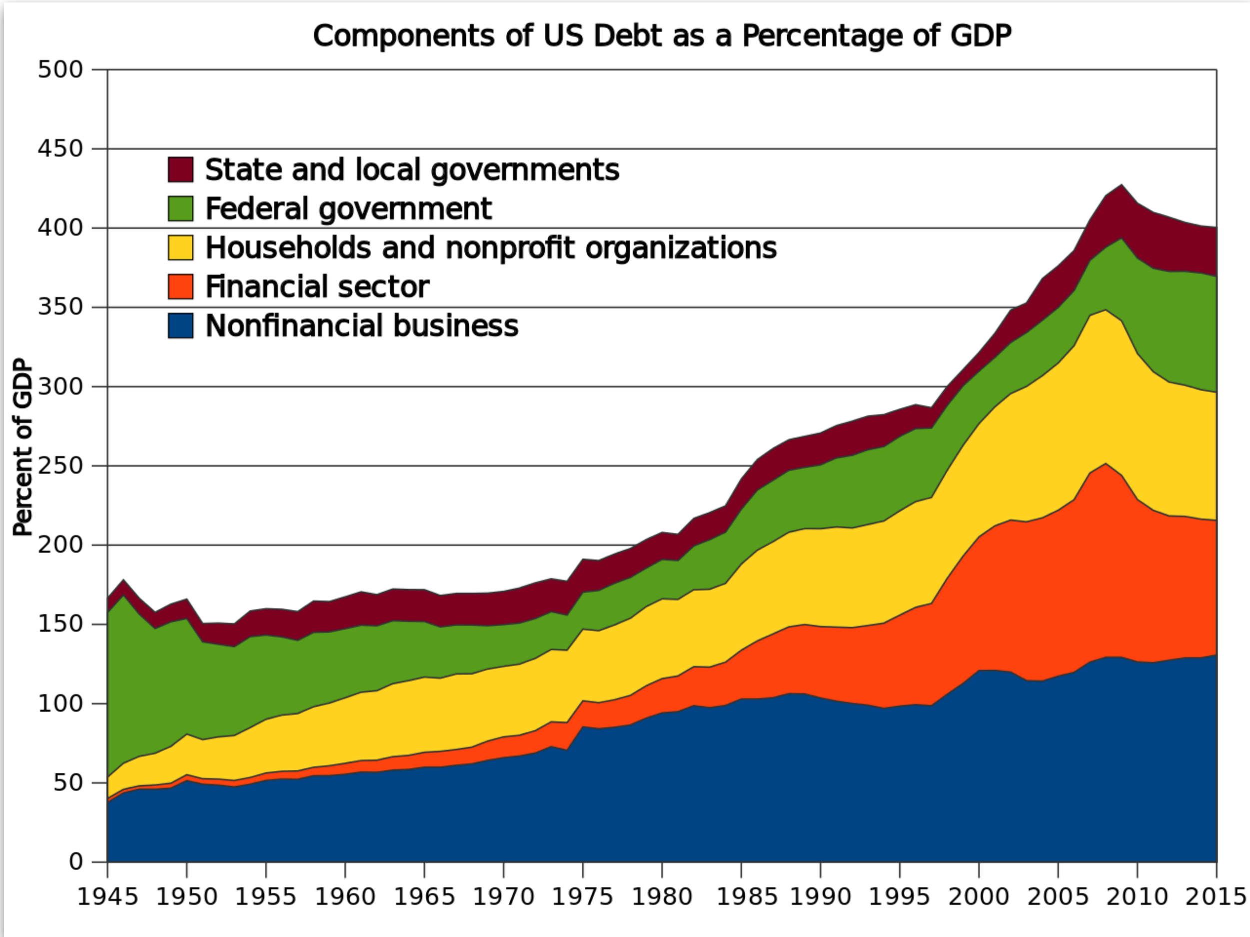
But in the 1970s, the cork of consumer protection started coming out of the bottle of financial home-brew, a process whose progress accelerated every year. At first, the relaxation of laws governing usury or mergers, like President Jimmy Carter's support for deregulation of the airline industry, were presented in all sincerity as ways of opening markets and promoting competition and lower prices to the consumer. We did get low fare airlines as a result.

In 1978, a U.S. Supreme Court opinion permitted banks chartered by the federal government to charge higher interest rates. In 1980, a federal statute gave the same business advantage to banks chartered under state laws. Banks began to fund more and more consumer debt. Later, creditors entered into arrangements to pool many loans into one large consolidated note which could be sold to investors. The banks would take the proceeds of such sales and disburse the funds in new loans, expanding the amount of credit available to borrowers.

The resulting increase in total U.S. debt is shown in this chart:



The components of such increase in U.S. debt is shown in this chart:



Despite such warning signs, the deregulation of the financial industry accelerated under the presidency of Ronald Reagan and really picked up steam during the Clinton Administration. In the last years of the Clinton presidency, the Glass Steagall Act was repealed and the Commodities Futures Modernization Act de-regulated control of new financial instruments – over-the-counter derivatives in particular – created and sold from that time forward. The combination of these two acts made way for the ever more imaginative instruments for gathering investments and directing them into speculative, rather than productive, enterprises. The wholesale lunacy of this unbridling of the financial sector was the primary force behind the great market meltdown of 2007-08. Not that the meltdown was unforeseen. In the years preceding the collapse, a number of academics and business journalists accurately foresaw the outcome of a system that gathered more and more money and funneled it into speculative ventures.

But despite efforts to put the genie back in the bottle, the situation is only marginally better today than it was in 2008. The Dodd-Frank Act was a direct response to the need to impose new regulations in the financial market. The law created new supervisory standards for systemically important financial companies to prevent government bailouts when such large institutions failed from imprudent use of their funds. The Dodd-Frank Act also imposed on banks the Volcker Rule, which called for a strict demarcation between commercial banking in support of the real economy and firm investment in securities for speculation. The rule was clear, not at all obtuse, a return to the principles by which the American economy flourished in the 1950s and 1960s. But the fate of the Volcker Rule in subsequent years highlights the difficulty of stuffing that well-heeled, extremely arrogant genie back in that proverbial bottle (more on that later).

The Volcker Rule had three overarching purposes: 1) reducing the moral hazard of irresponsibility due to lack of accountability for consequences; 2) preventing banks that benefit from access to federal funding from shifting their trading risks back to the government; and 3) preventing bank self-interest in trading from harming their clients.

To implement the Volcker Rule, five separate agencies negotiated a lengthy regulation, most of it aimed at how banks operated on a daily basis. This extreme detail caused a lot of angst for banks. They were feeling very constrained by the restrictions and started complaining that the regulation was too complex to implement.

In retrospect, a CRT advisor said, the implementing regulations have been effective in preventing the kind of intense trading activity which lead to the 2008 collapse of credit markets and the failures of Bear Sterns and Lehman Brothers.

"If you accept that finance is a necessary element for our economy to function, the most important question is how to make it work to everybody's benefit," observes Gaurav Vasisht, Senior Vice President and Director of Financial Regulation Initiatives at the Volcker Alliance. But he has concerns: "We have legislators right now huddling with banks to come up with ways to drive up profits. They complain about the Volcker Rule but there's not much evidence that the rule curtails profits."

He also worries that the financial system still moves lots of money around but not much growth is thus added to the economy and too much money in the wrong places can do a lot of damage, concluding that "If you accept that finance is a necessary element for our economy to function, then the most important question is how do we make it work for everyone's benefit?"

TOP 10 BANKS

RANK	COMPANY	FEES($m)
1.	J. P. Morgan Chase.	$5517.62
2.	Bank of America.	$4945.45
3.	Morgan Stanley.	$4066.30
4.	Goldman Sachs.	$3852.95
5.	Credit Suisse.	$3434.32
6.	Deutsche Bank.	$3178.15
7.	Citigroup.	$3166.33
8.	Barclays.	$2793.70
9.	UBS.	$2362.69
10.	Wells Fargo.	$1597.19

World's biggest banks are ranked for M&A advisory, syndicated loans, equity capital markets and debt_capital_markets.

In recent years, a smaller and smaller percent of the money invested by the financial sector is being used to back business ventures – about 15 percent – while the rest is invested in fueling the financial market itself, a stifling situation in which a handful of individuals and investment firms have evolved into a growing plutocracy in which the bulk of money is made off money. Today, the financial sector currently takes 25 percent of corporate profits while creating only 4 percent of all jobs in America.

"We have tried to foster growth in the financial sector," says Dean Baker, an economist and co-founder of the Center for Economic Policy Research and one of the first voices in his field to cite the reckless course the U.S economy was following in the first seven years of the 21st century and to predict the size and scope of the market collapse looming in 2007.

"We need financial markets to support the economy but we need as small a finance sector as possible," Baker argues.

Others point to the need of an advanced economy for a robust financial sector. John Taft, Vice Chairman of RW Baird, a wealth management, capital markets, asset management and private equity firm, has written Stewardship: Lessons Learned from the Lost Culture of Wall Street to reinforce the need in finance for high standards of responsibility.


John Taft

"I would question much of this," he says. "And I'm not sure I prescribe to the basic premise. It's true that share of the GNP the finance industry represented grew exponentially before 2008. But that was an effect of excesses in the years leading to crisis."

Today, Taft argues, the playing field looks a lot closer to recent historical norms than the out-of-control conditions leading up to 2008. In 2019, financial institutions are considerably less leveraged than they were in 2008 or 2009. "There's been a shrinkage due to de-leveraging," he says.

For Taft, finance has a critical role in modern capitalist economies. It is impossible to imagine the improvements in economy without financial sector, he believes. "Finance has a role to play. We are a means to social goals. We are not an end in itself. When we forget that and think of only enriching ourselves and the people. When we get out of whack, we get in trouble."

"Right now," Taft argues, "the financial sector is functioning in a way it is supposed to."

"Finance is an enabler, a means to an end. Our problem now is we don't know what we want. Financial crises bring a call for moral capitalism but Trump got elected on a platform of growth by any means."

For Taft, balance is critical: "It is certainly true that the over-financialization of our economy is harmful rather than helpful."

Yet, he too worries that our financial system has become a whipping boy for other problems in the economy.

"I believe that crony capitalism is a problem whose effects are being seen in political systems. But that problem is not caused by the financial sector which merely responds to the dynamics generated by those seeking election and re-election."

The View from Europe

by Richard Broderick

The financialization of economies is not, of course, confined to the U.S. It also flourishes in Europe, though not to quite the same degree, with the exception of Great Britain. To get a view of the situation in Europe, we turned to Cosima Barone, the founder and chairperson of the Swiss investment, research and market analysis firm, Finarc.

Rich Broderick: What, in your view, are the principal causes of the financialization of Western economies?

Barone: Financialization, intended as a dominance of finance over industry and the growth of the financial sector in its operations and power, has been going on, with ups and downs, for thousands of years. Therefore, the growing importance of finance in the modus operandi of our capitalist system is not a new trend. But honestly, we could ask ourselves at which level the creation of money is no longer producing wealth and to the contrary, is having a negative effect on growth?

The increasing importance of finance, financial markets and financial institutions to the workings of the economy has, in the last few decades, taken some specific forms and shaped patterns of inequality, culture, and social change in the broader society around the world.

How finance is intermediated in an economy — that is, how money is channeled from savers (investors) to borrowers (households, companies, governments) — has paramount importance. Financialization is best described by a broad shift in how capital is intermediated, from financial institutions to financial markets, through mechanisms such as securitization (turning debts into marketable securities).

Financialization occurred through the large-scale expansion and proliferation of financial markets in so many countries since the 1970s and was especially helped by (a) de-regulation of the financial system itself and (b) an important technological innovation. That is when "rent-extraction" (in the form of fees, commissions and trading profits) became the new fashionable trend that goes well beyond the traditional intermediation-based income. The resulting expansion and proliferation of financial instruments and services can be associated with the birth of a whole range of financial institutions and markets, sophisticated financial instruments and corresponding acronyms that are bewilderingly complex. Moreover, when most engineers coming out of university only want to work on Wall Street and design complex financial algorithms, it's quite evident to me that something complex financial algorithms, it's quite evident to me that something is badly wrong. Speculation has stealthily taken leadership. Making money with money has become more important than financing economic projects more intended for the common good. What good can come from the current acceleration towards financial automation, big data and high-frequency trading? Why, in modern finance, is any kind of cash flow securitized and turned into a financial instrument? Is it good for the "people?" Furthermore, do exchange-traded-funds (ETF) represent any core value for the investor? What does an ETF owner truly own? Definitely not pieces (shares) of any of the companies included in the ETF.

The U.S. clearly stands out as the most financialized economy. However, such a change came eventually also to continental Europe, though there is still a big difference, as finance over here is still mostly intermediated by banks rather than by financial markets. Even worse, by mutual shareholding, banks and companies are closely tied one to another across Europe.

Europe has always been behind Wall Street. It was only in 1983, for instance, that mutual funds were launched in earnest in Italy, attracting huge amounts of domestic savings. Sadly, it turned out that mutual funds were "bought out" by investors, instead of being intelligently and professionally "sold" to the Italian crowd by the financial industry. Inexorably, the day of reckoning came in 1986 when the stock market literally crashed (a year in advance from the infamous 1987 Wall Street crash) because there was no more liquidity left to be channeled into the newly born mutual funds industry.

Another important cause of financialization has been the unbridled creation of liquidity by central banks and other financial institutions (including shadow banking as network-finance). For instance, in Europe, when the European Central Bank (ECB) embarked into unorthodox creation of money in the aftermath of the 2008 financial crisis, banks did not extend lending to corporations and households but instead re-deposited their capital in the ECB. The resulting effect on the economy has been recession and stagnation for quite a long period. When the economy eventually showed some signs of recovery, the result has been frail and unable to last. In a free market economy, failing companies (and failing banks) should be allowed to go bankrupt. Pretending that central banks' largesse is conducive to financial stability is pure illusion, also distorting the primary role of financial markets to vehicle savings to productive use for the good of all.

Lastly, globalization (trade and finance) came to extremely exacerbate the above-described trends. The so-called 'rich nations' (notably over indebted) are currently experiencing great inequality, a melting down of their middle class that severely threatens global growth, a flattening of income growth, rising living costs and less stable jobs that might eventually fuel political instability.

Broderick: When did the process begin in France (and Western Europe) toward the economic situation we find ourselves in today — i.e., growing inequality, stagnant middle class income and more and more wealth funneled into the hands of the superrich? For example, in the U.S., it began in the late 1970s with a Supreme Court decision effectively banning usury laws at the state level, opening up a huge opportunity for the credit card industry. It escalated in the 1980s under Ronald Reagan and then got a real boost in the Clinton administration with the repeal of regulations adopted after the 1929 stock market crash that helped separate commercial from investment banking. Were there similar events in France?

Barone: To me, the key date that I have identified for the acceleration in the financialization process in the U.S. is May 1, 1975. I remember that very well, as I began working in finance with Wall Street firms back in 1973. On that day, commissions on transactions were no longer based on the NYSE fixed system but negotiated. The change was rather dramatic, with some institutions being able to negotiate up to a 70% discount. In my humble opinion, Wall Street firms had to become very inventive in order to fill the void caused in their revenue line by so dramatically diminished trading commissions. That led to "rent extraction" or an era of sophisticated, complex derivative financial instruments. However, the effect in the NYSE daily volume of equity intermediation occurred almost 5 years later when it made a quantum leap, jumping from barely 10-15 million shares on average a day up to 100+ million thereafter.

Europe normally follows Wall Street trends with some delay. As I mentioned earlier, on this side of the Atlantic, companies and households are still mostly financed by the banking industry, even though not exclusively.

Broderick: What are the problems, short and long-term, that this trend spawns?

Barone: Problems that come to mind are:

1. Financial: huge debt accumulated by states, companies and households will have their day of reckoning; furthermore, ETFs might cause a financial crisis going forward; last but not least, systemic crises are an integral part of finance-led capitalism in, for example, asset bubbles.
2. Economic: risk of a stagnation-deflation era.
3. Political: instability since bipartisanism is put aside and there is no clear leadership emerging; political elites no longer have the trust of the people.
4. Social discontent and unrest.

Broderick: What are some of the things that we could be doing to curb the devolution of the capitalist system?

Barone: I strongly doubt that, since the capitalist system has become so accustomed to speculation (making money with money while ignoring other people's interest), such a trend could be easily reversed. In my opinion, it will take a monumental crisis to get to a sense of reckoning. I am very skeptical that just a few measures, here and there, might have a chance to reverse such a trend.

Attempts by the so called "ecological capitalism model" (i.e. Network for Greening the Financial System to which central banks are adhering) to cap the highly aggressive expansion of finance, even though ambitious, have a good chance of being inefficient, if not failing altogether.

What worries me immensely is related to a dangerous power shift:

1. Neither nation states nor central banks hold power any longer (economic and political).
2. Media has gained a lot of power across the planet.
3. Finance and large tech companies are pushing governments around.
4. The age of surveillance capitalism might change our lives, along with the economy, politics and society (see, for example, The Age of Surveillance Capitalism, by Shoshana Zuboff).
5. A cashless world.
6. Loss of individual rights, including property rights, through confiscation of private savings by states (bail-out) or by non-state entities (bail-in).

Broderick: Are there European figures who seem to be pushing for the right kind of reforms and what are their chances of success?

Barone: At the present time, there are no emerging "outstanding" leaders with ambitious and pragmatic ideas of basic reforms, as well as with the ability to communicate them in a way that suffering populations might understand and accept. A leader, in my opinion, should know the past and have a vision for the future! There is no such leader over here. Moreover, the whole European Union build-up during the last 60 years was done in the absence of efficient communication to the people. As a result, cracks in the European Union are evident, as well as cracks in the European monetary system that was built in a way where member states are bound to be, sooner or later, bankrupt. As a European (Italian born), being naturalized in Switzerland, I am much happier to live in Geneva, Switzerland, than in my native country or any other European member state.

Caux Round Table for Moral Capitalism's
Code of Conduct for Banks and other Financial Intermediation

(Drafted at the request of John C. Whitehead, former Co-Chairman of Goldman Sachs)

Mission: Our mission is to provide liquidity to empower economic growth and prosperity on reasonable terms commensurate with assumed risk. We recognize that social well-being depends on the quality of our services.

<u>Standard of Due Care</u>

As stewards for both of those who provide capital and those who use capital, we will be prudent and diligent in our valuations, providing sustainable liquidity support and reasonable returns commensurate with assumed risk for our customers. Our duty is to provide effective risk management for the benefit of our stakeholders. As part of this standard of due care, we will be knowledgeable about what constitutes best business practices and will instruct our managers to accept nothing less than the most thoughtful and responsible practices.

<u>Compensation</u>

We seek no more than a level of profit commensurate with the value we create for our customers and we will compensate our employees appropriately in line with common best practices in our society and generously commensurate with their successful implementation of this code of conduct.

<u>Duty of Loyalty</u>

As stewards and trusted intermediaries, we will avoid conflicts of interest with our customers, placing their interests above our own and will require faithful execution of such responsibilities on the part of our employees. We will safeguard customer information and will not misuse information for our own advantage.

<u>Criminal and Illicit Activities</u>

We will not tolerate or facilitate any criminal or illicit activity, nor knowingly engage in any violation of laws and regulations.

Stakeholders, Communities and the Natural Environment

We acknowledge our ability to enhance the well-being of all our stakeholders, the communities in which we do business and the natural environment supporting those communities, both domestic and global. Acting in good faith, we will not knowingly bring harm to our stakeholders, the communities in which we do business and the natural environment supporting those communities. We will act transparently, according to our best judgment, to maintain a balanced and sustainable approach to promoting the well-being of those stakeholders, communities and natural environments.

Governance and the Public Trust

We will adhere to best practices of governance, insuring maximum material transparency, fairness and honesty in our communications and prudential accountability to our stakeholders.

Wall Street and the Behavioral Science of Making Culture Ethical

On 26 Feb, 2019 By Brian Gallagher

(reprinted from Ethical Systems)

Before he became "The Wolf of Wall Street," Jordan Belfort, when he arrived in New York in the 1980s, was more like a starry-eyed sheep. That's how Leonardo DiCaprio plays him in The Wolf of Wall Street, the film adapted from Belfort's 2007 memoir of his years as a stockbroker. In an early scene from the film, Belfort brims with a rookie's optimism about starting at investment banking firm L.F. Rothschild, under stockbroker Mark Hanna, played by Matthew McConaughey. He can't wait to help make Hanna's impressive clients more money, but he learns that isn't quite Hanna's modus operandi. "F[—] the clients," Hanna tells Belfort. "Your only responsibility is to put meat on the table."

To say this sort of nihilistic, self-serving attitude illustrated a cultural problem in the financial industry would be putting it lightly. It was more akin to a cancer, one that Henry Engler—a Thomson Reuters editor and writer who focuses on global financial regulation—was stunned to see metastasize in the short time after the October 1987 stock market crash. "What followed was a series of events that led to one of the biggest scandals in the industry's history," Engler writes in his new book, Remaking Culture on Wall Street: A Behavioral Science Approach for Building Trust from the Bottom Up. A couple months later, one of Wall Street's most powerful speculators—a man Engler almost dropped out of NYU to work for—was jailed for several years for conspiring to file false stock trading records: Ivan Boesky. "The charges exposed what had been a secret web of traders, with Boesky at the helm, dealing off of proprietary information and reaping enormous amounts of profits," Engler writes.

The scandal affected Engler in two ways, the first being that his rose-colored view of the industry was shattered. "It demonstrated that what at first glance might appear to be superior knowledge and expertise was actually fraud, fueled by excessive greed and a willingness to break the law." The second had him reflecting on why he turned down the job offer with Boesky. What he didn't know then was that he could understand his decision to stay in school under the rubric of "loss aversion," the idea that losses are anticipated to hurt more than gains are to feel good. Engler has since realized that misbehavior in the financial industry can be understood scientifically—and that behavioral science, particularly after the 2008 financial crisis, can reveal a better cultural path forward. "What behavioral science tries to do," he writes, "is understand what motivates individuals to make decisions, even if at times when those decisions don't seem to be in their best interest."

As the editor of regulatory intelligence at Thomson Reuters, Engler writes on a range of issues, including conduct, cultural and ethical issues, as well as the potential impact of events such as Brexit. He also covers regulatory developments in the derivatives markets and other major capital markets. What's more, he's organized forums for Thomson Reuters clients on issues such as cultural reform and how banks and regulators are coping with misconduct and ethical issues among their employees.

Ethical Systems recently caught up with Engler to hear how he sees the way behavioral science can help organizations, particularly in the financial sector, assess and reform their cultures to make them more ethical.

Your most recent book, Remaking Culture on Wall Street, came out a few months ago. Why do you place so much importance on trust?

Trust is a critical factor in the cultural makeup of any institution, whether inside or outside the financial sector. The financial crisis exposed what for many was a sharp decline in trust in many respects: between firms and their customers; between employees and their managers, as well as between regulators and the organizations they oversee. Re-establishing trust, particularly at the organizational level, is essential in repairing the damage that we witnessed during and after the 2008 crisis. It's an issue the industry is still struggling with.

How does trust interact with increased surveillance?

Ideally, you want to have an internal culture that doesn't require employee surveillance. But in today's environment, surveillance is widespread, particularly in financial services. You have to ask: Why is that? This goes back to trust and the diminution of trust between management and their employees. If you can't trust your employees to carry out their tasks in an ethical fashion, then the response is to monitor them. But as with the development of "reg-tech" tools, surveillance is an outcome or symptom of a culture that lacks trust; it's an indication of an environment where there is lack of a shared purpose. From an ethical standpoint—and I'm not an ethicist—I think many employees in financial firms understand that they are being monitored. This has become part of the bargain with their employers. For individuals who don't wish to work in such an environment, I suppose one can argue they can seek employment elsewhere. Unfortunately, given all of the scandals and problems we have witnessed within the industry over the past ten or more years, surveillance is now part of the landscape. It is very unfortunate, but again points to the lack of trust.

What is "reg-tech," or regulatory technology, and how do you think it will shape the way companies seek to better their cultures?

I see these new and emerging technologies as a powerful tool that companies can use to help identify areas of their organizations where there might be hidden risks. For example, such tools could be used in identifying individuals who for one reason or another have great influence, both among their direct reports and also upward in the management hierarchy. Sometimes such "influencers" are influential for the wrong reasons, engaging in behavior with clients, or also internally, that masks activities that could put the firm at risk. So, I see technology providing management with another tool to help find those blind spots before they become magnified. But cultural reform cannot be achieved simply by employing innovative technologies. It's a tool to help you mitigate risk and then hopefully you can take steps to prevent those risks from re-emerging. But the latter is the hard work of personally engaging employees.

What do you make of the possibility that banks may soon be required to have a "digital ethics" officer to ensure the integrity of business processes as they adopt "reg-tech"?

This is a very new and important development to the extent that technology continues to replace individuals in the business activities of banks. There is little reason to expect that banks will slow down their application of technologies where they believe they can achieve cost savings and also provide the same, if not better, services than before. But if the "machine" is now making decisions, how it makes those decisions becomes critical. After all, algorithms are designed by individuals, and it becomes imperative for those running a business to understand what is going into those algorithms, even though they may not have all of the technical knowledge to develop them. This is where there is scope for a so-called "digital ethics" officer, someone who has the technical knowledge that can sit alongside both the tech and business people to ensure that what the "machine" is doing is what we want it to do rather than putting the organization at risk. It's early days, but I can see this trend accelerating as banks continue to apply technology across many of their businesses.

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How are banks using the tools of behavioral science to combat misconduct and better understand the internal workings of their cultures?

There are some banks, particularly in Europe, who have created behavioral-risk teams to supplement their compliance and risk-management functions. These teams are comprised of individuals trained in organizational psychology, for example, and who are tasked with identifying possible "blind spots" within their organizations in terms of employee behavior. The objective of these units is to apply some of the tools of behavioral science in mitigating employee risk—in other words, identifying areas of the institution and individuals that pose a risk, and trying to manage those risks before they escalate.

What's an example of how behavioral science can help address the risks employees can pose?

From conversations I've had with behavioral risk teams at some European banks, part of their remit is to embed themselves among business units where there is a perceived risk or problem. For example, they are able to attend meetings, interview members of the business unit, conduct surveys and hold focus groups in order to better understand how these units function. In the course of such "deep-dive" assessments, members of the behavioral-risk teams are able to identify patterns of behavior among the staff or the managers leading a business that may warrant some form of intervention. An example might be weekly staff meetings where there is clearly an atmosphere where the managers are not challenged by the staff on any issue. The staff appears to be following the directions by managers irrespective of whether they believe they are conducting business in a proper fashion. Behavioral-risk team members may be able to pick up on such reticence by the staff by sitting in on business-unit meetings and then follow up individually with staff members to determine whether their perceptions are correct. If so, then the behavioral-risk team will incorporate their observations and findings in an overall assessment of the business unit and make recommendations to the business heads—both those managing the unit and those above—that should be incorporated. In this example, the recommendation would be to develop a "climate" where employees are encouraged to speak up and question management decisions if they have concerns.

What are the biggest blind spots large banks have in their conduct and cultural reform programs?

While nearly every large organization now has the so-called correct "tone from the top," the hard work of cultural reform is really within the rank and file staff, particularly among middle managers, who are tasked with often high-performance objectives. It's an area where, while on the surface a business unit might seem successful—say, when measured in its contribution to the bottom line—how it has achieved those results may be harder to understand. For example, does a successful part of the organization treat its customers fairly? Or, is it engaging in business practices that are deceptive or fraudulent? Also important is the environment or "climate" that exists within a business unit. Do the managers allow for dissenting opinions on how they deal with their clients or each other? Can managers be challenged by employees? If not, then employees may be reluctant to speak up when they see behavior that might pose a risk to the firm. One often has to understand why successful units within a large organization are able to achieve their success. This is an area where often more senior people simply accept the end results at face value. We have seen—and unfortunately continue to see—examples of individuals who are successful and influential within their organizations achieve those outcomes by means that have proven detrimental to the firm.

The U.S. financial system has so far failed to improve data quality and standards that regulators use—is that a culture problem?

I don't see that as necessarily a "culture" problem, but rather more of a "collective action" problem, where it is difficult to organize both firms and regulators around agreeing on common data standards, and thereby improve quality. In rallying the industry around such a goal, you will often find those who are willing to put in the hard work and others who, as economists like to say, go along for a "free ride." The U.S. financial system is a complex and fragmented regulatory system, which makes agreement among regulators more difficult. So, it's less about culture, and more about structure, incentives, and organization.

When it comes to reforming culture, why might boards and senior executives be too eager for results from changes or policies aimed at addressing perceived problems?

The short answer would be that they lack an appreciation of just how hard it is to turn a company's culture around. Culture is not something you can reform overnight, especially if in the past there was a certain way of doing things that was widespread, condoned by both senior and middle management, and where many of those who engaged in the old way are still around. I've had senior U.S. regulators tell me that cultural reform could be a generational issue, something that can only truly change over time as an organization's people change.

No doubt generational change is important. Does that mean companies should introduce new hires to their culture's values and norms in a concerted fashion?

Absolutely. In fact, there have been suggestions in the industry that firms should incorporate ways of gauging a prospective employee's ethics and judgment in the interview process. This would be an attempt to determine how employees might behave or react in situations where there are clear ethical or behavioral choices. Certainly, once onboard, new hires should be made to understand the importance that the company places on its values and culture, and that this will be considered in the overall review process for employees. There are actually some large companies who are including an ethics assessment of employees which will determine whether they receive annual bonuses. The Swiss pharmaceutical company Novartis, for example, announced last year that is was incorporating an ethics evaluation in their employee review process.

What's the right way to think about the problems certain subcultures in a company can cause?

This is problem that exists primarily within large, complex organizations, where you have multiple businesses operating around the globe and which, over time, develop their own language, ways of operating, and in the worst case become divorced from the cultural and ethical principles of the firm. It is hard for management at the top of such organizations to have clear insight into businesses that develop their own "sub-cultures," and the effort required can be considerable. But another factor is simply the diverse nature of the multiple businesses that sit inside these complex institutions. The language and skills needed to be competitive in foreign exchange trading, for example, is quite different from those required in private banking. They attract different individuals and often require different skill sets. Also, the pace of their businesses are different—some, such as trading, are fast-paced, requiring employees to balance many risks and make decisions quickly. Others operate under longer-lead times, are more client focused—or simply require more direct contact with clients—which requires employees who have a longer-term focus. This diversity can lead to sub-cultures that can put the organization at risk, but they don't necessarily have to.

What is most interesting to you about the problems and challenges companies face in learning about their own culture, and improving it?

There are many, but I find that the biggest challenges are around engaging your employees in a way that they believe they have an important role to play, and that there is a shared purposed across the organization. Very much related to this—and I think this is particularly true in financial services—is the idea of having a career and believing that your management is truly interested in your long-run well-being within the organization. Unfortunately, over time, many employees realize that they can work hard, keep their nose clean, and still find their jobs at risk due to circumstances beyond their control. The notion of having a long career on Wall Street is simply not what it once was. This, of course, is due to many changes, not least the way business has changed at large companies. The short-term nature of the business has led to decisions that impact employees to a much greater extent than before, and this has led to a degree of cynicism and self-interest, or self-preservation. In other words, employees have less loyalty to firms. How do you change this? I'm not sure, short of the management of these organizations looking at their business models and striving to re-instill longer-term objectives and goals for their organizations. On the optimistic side, there are increasing pressures for management to look beyond shareholder value as their sole business objective. This is a dialogue that is growing and how it plays into the management of financial service firm will be interesting to watch.

You'll be speaking on a panel at our conference, "Ethics by Design: Managing organizations in an era of anxiety, polarization, and disruption." What role do you think gatherings like these play in shaping cultural change in organizations?

I think these types of forums allow for an exchange of ideas on these very difficult issues and enable participants to hear and learn about what leading researchers in the field have found. In addition, by including organizations that are tackling these issues internally, participants have a way of perhaps linking theory to practice. This provides them with insights and information that they might wish to incorporate in their own organizations. Since these are complex issues, where there is often no toolkit or ready-made solution, having a chance to listen, discuss and exchange ideas is critical in furthering progress for both academics and industry practitioners.

What drove you to write a book on what Wall Street could learn from behavioral science?

I think the primary motivation was from seeing the frustration among many banks in tackling behavior and culture issues, and then finding a small group of banks and supervisors—primarily in Europe—who are trying a different approach—using tools from behavioral science to supplement their existing efforts. I believe there could be a lot of—to use the Wall Street term—return on the investment for banks who develop such tools and create teams to apply them in practice.

Brian Gallagher is Ethical Systems' Communications Director

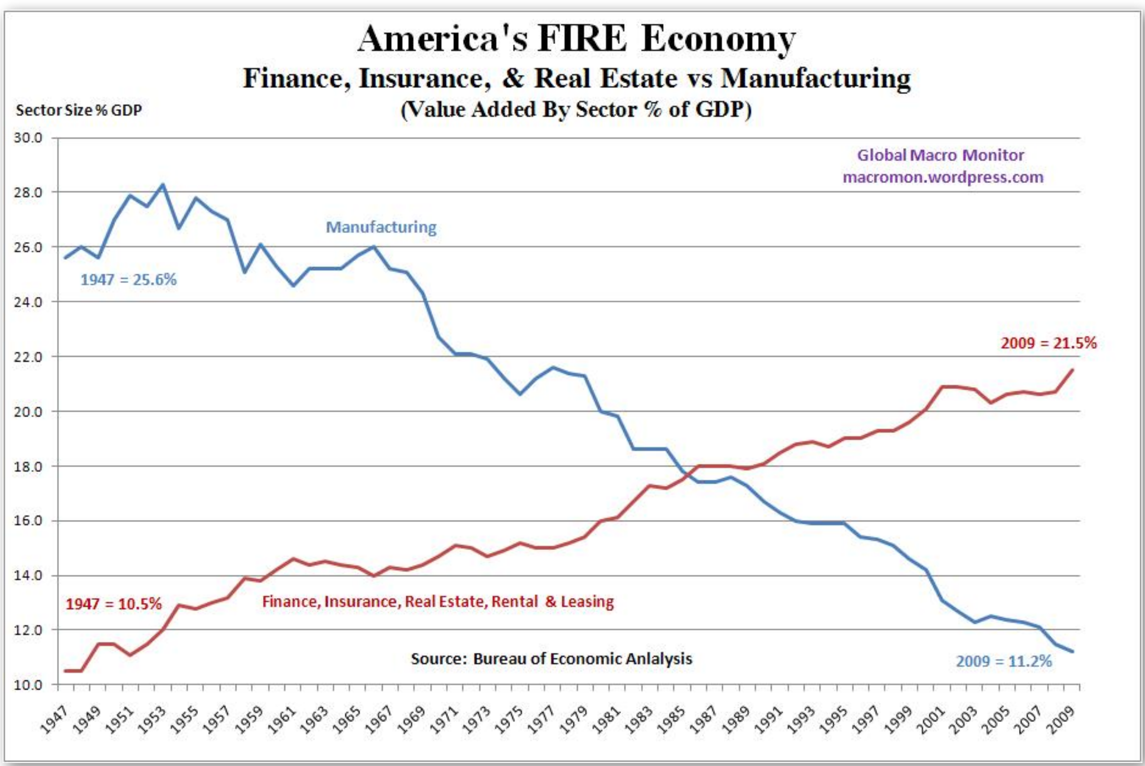
Outro

One fact about our global civilization which emerged dramatically after the collapse of credit markets in 2008 is that, once again, capitalism has moved on from where it was. It has evolved so much that it should be considered a new species of its structural genus. As Karl Marx crudely suggested, capitalism, as a social life-form, has stages. In retrospect, the relevant stages were not as Marx thought them to be. Capitalism itself is not being replaced by socialism, by state administrative control of the economy - production, savings, investment, innovation, distribution of wealth and income and growth in keeping with human desires. Furthermore, capitalism has now expressed itself in various sub-stages.

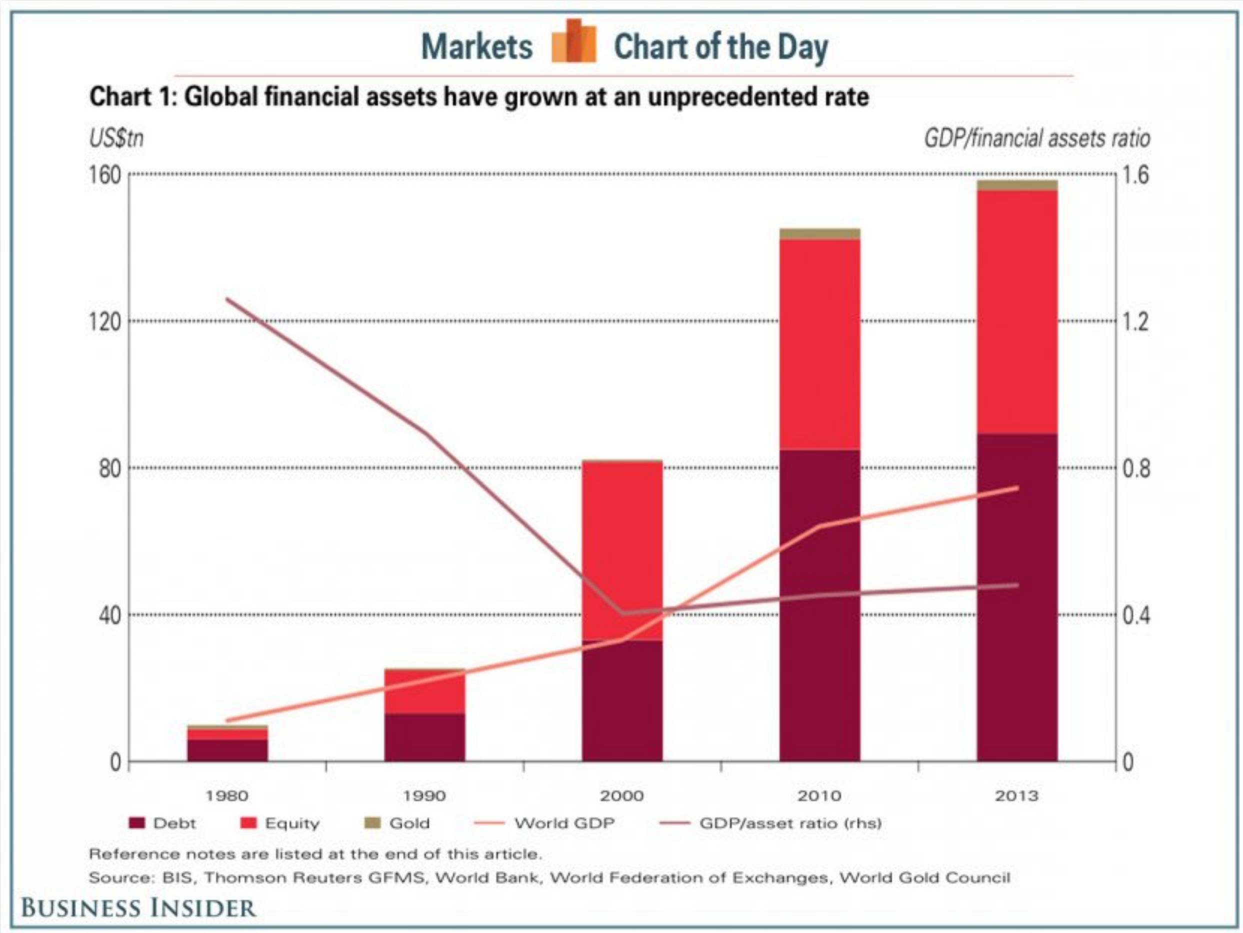
We experienced primitive capitalism arising in the 1600s, then industrial capitalism starting in the 1700s and blossoming over the next 200 years to be superseded by post-industrial capitalism in the 1970s. At every stage, innovation producing the invention and calling forth the propagation of new technologies caused changes in production and consumption and increased human well-being.

In the 1980s, we started to live with and benefit from the evolution of post-industrial capitalism into its current form of "financialism." In short, financial intermediation became more and more central to the making of wealth, as new forms of capital – intellectual, social, digitalized data – needed to be deployed to enhance productivity.

The following chart illustrates the rise of financial services:



This chart shows the growth of financial assets globally:



Our friend, Lord Robert Skidelsky, has just written a summarizing book on economic theory titled Money and Government: The Past and Future of Economics which points to the need for a reconsideration of the elevation of microeconomics to the position of highest regard in thinking systemically about capitalism. He observes that the ten largest banks in the U.S. now control 75 percent of American assets, as opposed to only 10 percent in 1990.

He wrote starkly that "the financial system caused the Great Recession" of 2008.

Once again, as capitalism introduces us to new dynamics of wealth creation which both upset previous modes of production and consumption and subject some of us to new upsetting modalities of living, we need to stand back for a moment and take a systems approach to understanding the institutional arrangements of our time.

There can be no successful capitalism, in my judgment, without finance. But the factor of money not constrained by real factors of production and consumption has a freedom to disrupt incentives and risk/return calculations and so to chart its own course, enticing the entire system to support the growth ambitions of a sub-sector.

Since the tulip mania of 1636 and 1637, the institutions of capitalism have been unable to provide remedial checks and balances on the power of money and finance. Now, finance has been empowered by new institutions of fiat currencies, securitization, protective haven jurisdictions and unprecedented extensions of credit.

The growth of financialism has coincided with increased inequality of wealth, giving the financial sector, acting principally through those who own liquid assets, new influence in the politics and culture of advanced economies. As a Marxist would say, "it is no accident, comrade" that populism and anti-elitism are the growth movements in contemporary culture and politics in many advanced societies.

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