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Banking on team ethics : a team climate perspective on root causes of misconduct in financial services

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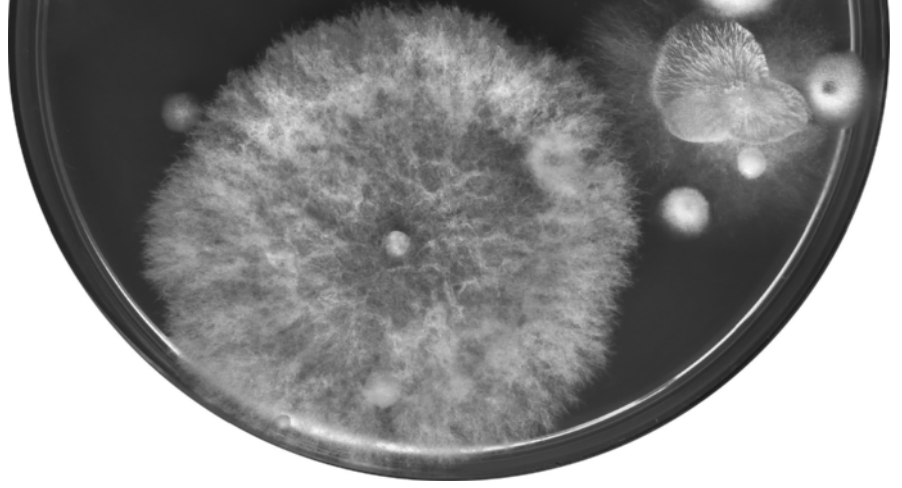


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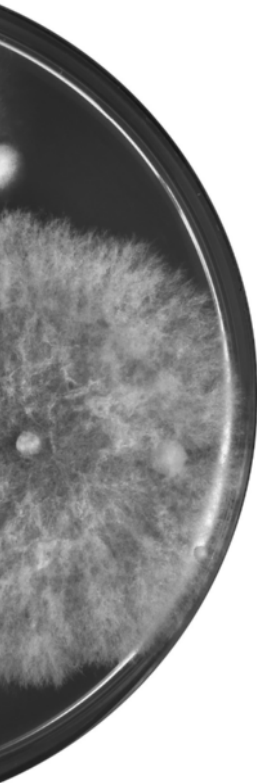
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Part I **Misconduct**

Chapter 3 Preventing misconduct: introducing a social psychological perspective



Chapter 3

Preventing misconduct: introducing a social psychological perspective

The recurring misconduct of traders within banking demonstrates that current responses of banks and financial supervisors are insufficiently effective in preventing future misconduct. Misconduct cases repeat over time at different banks. This implies that the lessons these cases bring forward, are not learned from effectively.

Taking into account the detrimental consequences of this misconduct for enduring financial performance, solidity of and trust in the banking sector, banks ought to do everything that they can to prevent future misconduct. Financial supervisors in their turn, ought to do all in their power to require of banks to effectively mitigate misconduct risk.

Limited causes and reactive response: the problem

The central problem, concerning the way banks and financial supervisors deal with misconduct cases, is twofold:

- A. Banks, and financial supervisors alike, have a limited view on what causes misconduct (characterized by 'bad apple'- thinking), and
- B. Banks, and financial supervisors alike, have a limited and mainly reactive response to misconduct; aimed at containment, disciplinary measures and decreasing opportunity for misconduct by the increase of controls.

Because of their limited view on causes, and reactive response, banks are insufficiently effective in preventing future misconduct, and financial supervisors are insufficiently effective in their requirement that banks should mitigate misconduct risk.

Root causes and preventive response: the answer to this problem

My analysis offers an answer to this central problem, that is again twofold:

- A. I reveal social psychological root causes of misconduct (characterized by 'corrupting barrel'- thinking), and,
- B. I offer a preventive response to misconduct, aimed at (1) defining team climate and identifying behavioural patterns that increase the risk of misconduct, and (2) improving these social psychological root causes accordingly to prevent future misconduct.

The central message my analysis conveys is that - by adopting this preventive response to misconduct - banks will be more effective in preventing future misconduct, and financial supervisors will be more effective in their requirement of banks to mitigate misconduct risk. In section 3.1 and 3.2 of this chapter, I will clarify the central problem and the answer proposed.

1. Causes of misconduct: bad apples versus corrupting barrels

Banks, and financial supervisors alike, have a limited view on what causes misconduct (characterized by 'bad apple'- thinking). First, I clarify this banking perspective. Second, I introduce the social psychological root causes of misconduct (characterising 'corrupting barrel'-thinking). Finally, I conclude this section by identifying the reasons for adopting the social psychological perspective on root causes of misconduct, and the reasons for questioning the current banking perspective.

A. Bad apples: a banking perspective

In the banking sector, the conviction that misconduct cases are a result of individual misbehaviour prevails. This thinking, where the individual is solely to blame for his or her misconduct, is referred to as the 'bad apple theory' (Treviño & Nelson, 2007; Kish-Gephart et al, 2010). A trader behaving unethically is a bad apple, that needs to be punished and removed from the barrel of healthy apples before it spoils the bunch. Now, some misconduct cases seem to support this bad apple theory. The next examples fit the bad apple explanation of what causes misconduct.

- *An illustrative example from supervisory practice (Nr. 6, see Table 2.1)*

A trader at a large systemic bank, was caught making huge deals with a single third party, increasing his P&L extensively. It was a pre-conceived set-up: the trader and the third party arranged this scheme before the trader started to work at this bank. The third party rewarded the trader for getting these great deals. Within a year after he was hired, the fraud was discovered by the bank and the trader was fired.

- *An illustrative example from supervisory practice (Nr. 1, see Table 2.1)*

"These guys want to rob my bank", uttered a CEO of a global significant bank during a discussion of misconduct cases within his investment banking division. With 'these guys' this CEO referred to the traders who were involved in the misconduct cases that were subject of this supervisory meeting with him. He implied that the traders that behaved unethically, were motivated by the aim of gaining money and 'stealing' from the bank.

The executive board member of this systemic bank commented: *"There will always be bad apples"*. In the executives' view misconduct cases like these will happen inevitably, because investment banking attracts people who are willing to behave unethically and illegally just to make money. In line with his remark, in supervisory interviews with executives and traders we hear statements such as *"It is an industry problem", "There will always be bad apples"* and *"This industry attracts this kind of people"*. Attributing the cause of misconduct even to a whole industry, is also a way of not dealing with this misconduct. If this is truly an industry problem, it will be a reality for trading businesses anyway. This attitude calls into question whether preventing misconduct from traders is even feasible.

This reasoning also assumes that stable dispositions drive people's behaviours, impervious to any feedback they get from others. Personality is considered as a stable constitution and often seen as the only explanation and driver of behaviour in a professional context. Some even hypothesize that successful bankers move up to senior management positions when they are extremely aggressive and completely lack empathy – associated with psychopathic or deviant personalities⁵.

- *An illustrative example from supervisory practice (Nr. 7, see Table 2.1)*

During a supervisory interview with a CEO on the group dynamics within his management board, he discussed the ineffective behaviour of one of his executives. This behaviour included for instance the withdrawal from group discussions, and hostile communication. We asked the CEO why he did not address this detrimental behaviour, as the chair of the management board meetings. He stated: *"That is just the way he is"*. He considered individual behaviour as reflecting stable differences in personality. 'One acts as one is'. In this line of thinking, talking about this behaviour, or giving feedback to someone who behaves inappropriately, has no use.

The 'bad apple' theory is also reinforced by media reports, targeting individual traders as principal wrongdoers. Mr. Iksil, the trader involved in the London Whale case (see Table 1) opposed the 'bad apple' thinking of the media in his public letter to the press⁶. *"Publicity surrounding the losses sustained by the CIO of JP Morgan typically refers to 'the London Whale' in terms that imply that one person was responsible for the trades at issue,"* wrote Mr Iksil. *"In fact the losses suffered by the CIO were not the actions of one person acting in an unauthorized manner. My role was to execute a trading strategy that had been initiated, approved, mandated and monitored by the CIO's senior management"*.

Investment banking and financial supervision are – logically so – sourced with employees with economic backgrounds. Professionals with these backgrounds often consider human behaviour from an economical perspective; assuming all behaviour to be a result of conscious thoughts and explicit decisions. How a person acts, or what he chooses, is seen as an outcome of a 'calculation' of information and experiences. In this perspective, individual behaviour is the outcome of an explicit cost-benefit analysis, resulting in a rational choice to act. The benefits are the rewards (like money) every individual wants to maximize: the key assumption is that human nature is to primarily serve one's self-interest. The cost of misbehaviour is determined by for instance the chance of getting caught and the severity of the (financial) sanctions. This perspective on human

⁵ The Guardian: September 20, 2015. 'How psychopaths can save your life'. Available at: <http://www.theguardian.com/lifeandstyle/2015/sep/20/how-psychopaths-can-save-your-life>

⁶ The Telegraph: February 23, 2016. 'JP Morgan's 'London Whale' trader breaks his silence'. Available at: <http://www.telegraph.co.uk/business/2016/02/23/jp-morgans-london-whale-trader-breaks-his-silence/>

behaviour is often referred to by the term 'homo economicus', introduced by Adam Smith in the 19th century (Coase, 1976). In essence, the homo economicus perspective relies on an understanding of rational processes at individual level, that leads to behaviour or decisions. This perspective does not acknowledge that rationality is bounded by limits in information, time and the capacity to process and weigh this information cognitively (Simon, 1982). It also tends to neglect effects of multiple other influences on decision making such as contextual or social influences. The homo economicus perspective therefore aligns with the bad apple theory regarding misconduct, and is a possible explanation for the fact that bad apple thinking prevails in investment banking and financial supervision.

B. Corrupting barrels: a social psychological perspective

The social psychological perspective on misconduct opposes the banking perspective and its bad apple thinking. This 'corrupting barrels' - perspective on misconduct of a trader, is that the professional context the trader is part of, harbours social psychological root causes of his or her misconduct. The traders that behave unethically, are socialised and work in a professional context that evokes or drives their misconduct. Rogue traders are not just bad apples spoiling the barrel. According to the social psychological perspective, it is likely that the barrel has contributed to corrupting these apples.

I propose to assess these root causes of unethical behaviour at team level. The characteristics of trading team climates can elicit problems and form root causes for misconduct of its members (Scholten & Ellemers, 2016). Before we focus on *which* social psychological root causes within teams are relevant for analysing and preventing misconduct, we first briefly touch upon the empirical evidence of groups and group norms influencing the individual behaviour of their members.

Our individual behaviour at work is influenced by our direct social context: the team we work in. This is in line with the general concept that groups and the norms within these groups influence the behavioural choices of their members. *"Although people often tend to consider themselves and others as unique individuals, there are many situations in which they think, feel, and act primarily as group members"* (Ellemers, 2012). This insight is at the core of social psychology, and the body of research that supports this insight has accumulated over decades (see for a review Ellemers, 2012; Haslam, Reicher & Platow, 2013). The group we belong to also affects our *ethical* behaviour (see for reviews on antecedents of ethical behaviour: O'Fallon and Butterfield, 2005; Tenbrunsel and Smith-Crowe, 2008). That is, the people in our direct social context in our professional environment – the team we are part of, our colleagues and manager – influence the norms we set for our ethical behaviour at work. Our direct social context affects our moral compass and our moral decisions (Moore and Gino, 2013; Tomasello and Vaish, 2013; Kish-Gephart *et al.*, 2010). For instance, our group members help to establish a standard for ethical behaviour through their actions and omissions. These actions and omissions provide information on the relevant social norm within a group. This social norm tells its members what (ethical) behaviour is expected in a certain context and is considered appropriate or inappropriate (Moore and

Gino, 2013). So, when analysing the root causes of unethical behaviour of traders from a social psychological perspective, the trading team should constitute the appropriate level of analysis and is an important source of information.

Complement the 'bad apples' perspective with the 'corrupting barrels' perspective

I propose to complement the bad apple perspective by addressing social psychological root causes of misconduct that may be contained at the team level (Scholten & Ellemers, 2016). As indicated above, an extensive body of research shows evidence for the 'corrupting barrels' or social psychological perspective. The scientific foundations of this perspective will be explored in the theoretical part of my analysis (part II: social psychological root causes of misconduct). For now, there are at least four drawbacks of the 'bad apple' perspective, that I will list below.

First, the bad apple hypothesis does not seem to be supported by the misconduct cases within banking, that are known to financial supervision. Clear 'bad apple' cases, such as cases where it is evident that a trader entered a team with malevolent intent and single-handedly committed fraud within a short period of time after entering the bank, are the exception. In most misconduct cases, like that of Adoboli, Kerviel or Iksil, it is not at all evident that a trader behaved unethically because of a faulty individual moral compass, a bad character or because he was lacking norms of right and wrong. However, the social psychological root causes of misconduct are up to now rarely analysed. The 'corrupting barrels' perspective, with a focus on detrimental influences of team climate and the direct work context, has the potential to contribute to the clarification of what aspects led up to the unethical behaviour.

Second, the 'bad apple' theory does not explain why, within the same investment banking division, certain trading teams have a history of misconduct while other teams do not. Some trading desks within a bank have repeatedly seen misconduct of its traders, while other trading teams stay out of trouble. Organizational factors, like the focus on short term gains or the absence of ethical codes, that have been cited as potential system-level causes of misconduct are unable to account for these differences at team level. The 'corrupting barrel' perspective has the potential to explain this variation. The fact that there are 'hot pockets' in terms of misconduct risk within investment banks, imply root causes at team level and failing team leadership.

Third, the bad apple perspective suggests that individual level behavioural change is unlikely. Individual traders can simply be classified as 'good' or 'bad apples'. Further, the notion that a bad apple has to be removed before it can spoil other apples that were good, does not take into account that an apple that was once bad can 'turn good' again. This suggests that the primary way to prevent misconduct is to keep bad apples from entering the organization, for instance by introducing integrity assessments in personnel recruitment procedures or to get rid of them after they are exposed. In contrast, the corrupting barrels perspective offers concrete levers at team level, that can be used to prevent future misconduct of currently employed traders.

Fourth, the bad apple perspective is misaligned with information that is available about toxic leadership and unethical work climates that affect individual workers. These come to the fore very clearly in the observations of a Dutch journalist who spent a number of years in the London City, interviewing professionals in finance (Luyendijk, 2015). His reports in *The Guardian* revealed the significant impact of group dynamics and work climates on decision making in banking. Similar observations, calling for the need to address and reform aspects of organizational culture, have been made by financial supervisors (European Banking Authority, 2016), and are even acknowledged by the banks themselves (Banking Standards Board, 2016; Group of 30, 2015; Financial Stability Board, 2014). The 'bad apple' perspective leaves organizational culture out of scope. This misalignment between the 'bad apple' banking perspective, and the societal notion of culture as a cause for misconduct, creates a sense of detachment and incomprehension that is detrimental for the trust of private and corporate clients, the general public and society as a whole in banking.

In sum: defining individual misbehaviour as the sole cause of misconduct is insufficiently effective. Even though a trader who covered up a loss or manipulated an interest rate is to be punished, there may be root causes in his direct social context at work that have caused this trader to misbehave. These causes have to be examined and taken into account in order to effectively prevent future misconduct.

2. Responding to misconduct: reactive versus preventive

The persistence of trader misconduct in investment banking suggests that current responses of banks and financial supervisors to known incidents are insufficiently effective in preventing future misconduct. First, we identify three standard responses that contribute to this state of affairs: containment attempts, disciplinary measures, and increasing controls.

Then, this section touches upon some preventive measures the banking industry is taking, next to its reactive responses. These preventive measures relate to changes in incentive compensation structure, introduction of integrity tests and banking oaths, all aimed at encouraging ethical behaviour and integrity. Why these preventive measures, while well-intended, are insufficiently effective in preventing future misconduct is explained below.

Subsequently, I will introduce the preventive response to misconduct based on social psychological theory. To be effective, this preventive response should consist of a two-step approach, aimed (a) at analyzing social psychological root causes of misconduct within a team, and (b) at targeting these root causes to prevent future misconduct. This section concludes with the argument for investment banks and financial supervisors to adopt a social psychological approach to help prevent future misconduct.

A. Reacting to misconduct: a banking perspective

The currently observed limited and mainly reactive response of investment banks and financial supervisors alike to misconduct, can be categorized into three main reactions:

- a. Containment of the misconduct and a focus on damage control;
- b. Taking disciplinary measures against the 'bad apples', i.e. specific traders involved;
- c. Increasing controls aimed at mitigating opportunities for 'bad apples' to cross the line.

Below, these three reactive responses are explained in more detail.

Containment attempts

Attempts to control the damage of misconduct revelations often try to make the misconduct seem small and inconsequential. The severity of the misconduct is downplayed, so that public concern for its implications seems out of proportion. For instance, even though Jamie Dimon (CEO of JP Morgan) was praised for taking accountability later on, one of the first of Dimon's reactions to the 'London Whale' case (see Table 1) was to dismiss the stories as a 'complete tempest in a teapot'⁷. In this way, the serious and alarming nature of a misconduct case is downplayed.

The implications of misconduct are also mitigated by presenting these as isolated incidents, resulting from individual misbehaviour. The legal implications of organizational accountability form an obvious incentive to blame the individual trader or wrongdoer. As a senior lawyer of a global significant bank – with misconduct cases to deal with – indicated in a supervisory meeting: *"We cannot take any blame: that will not hold up in court if we want to get some of the money back"*. However, this legal containment strategy precludes the examination of possible causes in the organizational context that may have led to or facilitated the individual misconduct.

Illustrative of framing misconduct as the result of individual misbehaviour, is an interview with Dutch lawyer Peter Wakkie⁸. Wakkie is a well-known and seasoned lawyer, who specialized in advising corporate firms on how to deal with fraud. He is often consulted as an expert fraud cases, also by the banking sector. In fact, he is also a supervisory board member of ABN/AMRO Bank, one of the globally significant banks based in the Netherlands. In an interview in a leading national newspaper, headlined: "Discovery of fraud? Do not say anything and make sure there is cash", Wakkie lists five explicit points of advice for firms on how to deal with fraud. One of his five recommendations is to 'not take any blame' for what happened. He takes the 2015 Volkswagen emission scandal as an example. Wakkie expresses his relief when he read a press release of Volkswagen, stating that it was just individual misbehaviour that caused all the turmoil. He said: *"That is really good, encapsulate the event. This put me at ease right away"*⁹. Accordingly, banks tend

⁷ Financial Times, May 16, 2012. "How JPMorgan's storm in a teapot grew". Available at: <http://www.ft.com/intl/cms/s/2/6197eb2a-9f64-11e1-8b84-00144feabdc0.html#axzz43NiUNHNN>

⁸ NRC Handelsblad, December 19, 2015. "Fraude ontdekt? Zeg niks en zorg voor cash". Available at: <http://www.nrc.nl/handelsblad/2015/12/19/fraude-ontdekt-zeg-niks-en-zorg-voor-cash-1569537>

to share as little information as they can about misconduct cases as a damage containment strategy. A misconduct case is primarily seen as a legal liability, and for that reason, information tends to be shared on a 'need to know basis' only. It is understandable that banks prefer not to publicize misconduct cases to outside parties like financial supervisors or the media. However, withholding relevant information about past misconduct from others within the organization, prevents them from drawing important lessons.

- *An illustrative example from supervisory practice (Nr. 8, see Table 2.1)*

A trader within a global investment banking division, explained in a supervisory meeting: *"I know something happened at the desk two rows away from me on the floor, since someone was suddenly missing and fired. I got 'you do not need to know' as an answer to my questions. Soon after we got a training from Compliance reminding us of some legislation and procedures, I could derive somewhat what might have happened".*

Disciplinary measures

Next to containment, a second reactive response of investment banks to misconduct, is to take disciplinary measures against the traders involved. The misconducting traders in the cases summed up in Table 1 were all fired from the banks that employed them, at the time of the misconduct. Firing the individuals involved in case of unethical behaviour is common. Senior management are prone to firing traders who were involved in misconduct cases.

- *An illustrative example from supervisory practice (Nr. 9, see Table 2.1)*

"Tell me their names, and I will fire them all", uttered a CEO of a global significant bank during a discussion of misconduct cases within his investment banking division.

Another disciplinary measure that a bank can undertake, is to sue the traders involved in misconduct cases. With law suits, banks aim to hold the trader who behaved unethically accountable for the trading loss and the breach of regulation. Again, all traders involved in the cases listed in Table 1 were sued and sentenced to jail – except for Mr Iksil (the 'London whale') who was fined.

Finally, clawback and malus clauses are used by banks to control damage of misconduct. Clawback refers to recovering bonuses that were already paid out to the trader. Malus or holdback refers to revising or refusing payment that was agreed upon before, due to misconduct of the trader. The Prudential Regulation Authority (the UK's financial supervisory authority) is planning to ensure that malus and clawback can occur even after a trader has moved to another bank¹⁰.

Increase of control

⁹ In Dutch he stated: "Dat is heel goed, lekker inkapselen. Ik kreeg er gelijk een rustig gevoel van." See: <http://www.nrc.nl/handelsblad/2015/12/19/fraude-ontdekt-zeg-niks-en-zorg-voor-cash-1569537>

¹⁰ The Financial Times, January 13, 2016. "Bank of England tightens bonus rules". <http://www.ft.com/cms/s/0/709cab9e-b9e4-11e5-bf7e-8a339b6f2164.html#ixzz43TWEjEi>

A third reactive response to misconduct by investment banks, is to increase controls. Control functions as risk management, compliance and audit are expanded with resources. Limits and control frameworks are tightened; risk appetite statements are made explicit. The political and regulatory context of banks encourage this response. Politicians and regulators are creating more rules, more laws, more guidelines and codes banks have to comply with. The assumption is: by rules and regulation – we can control how banks act, and therefore decrease misconduct cases that hurt our economy and our society. Regulatory push is on increase of controls, assuming the lack of controls create opportunity for a trader to behave unethically, and so an increase of controls decreases this opportunity. Of course, an increase of controls can also be a signal to traders on the extent to which banks take misconduct cases seriously, and on what behaviour is ethical or allowed for.

Why standard responses are insufficiently effective

Focusing on containment, disciplinary measures and increase of controls is not sufficient to prevent future misconduct. Considering cases as isolated incidents caused by specific individuals leaves organizational causes of these cases unexplored. Containing information as a form of damage control impairs the possibility to learn from past misconduct. This contributes to the repetition of known problems, and the accumulation of misconduct cases.

- *An illustrative example from supervisory practice (Nr. 10, see Table 2.1)*

A senior compliance officer, at an investment banking division of a significant bank with multiple misconduct cases, indicated that none of these cases were used as 'learning materials' in Compliance training sessions for traders. Instead of their own cases, anonymized cases of other banks were used as illustrative training material.

Disciplinary measures too may not provide the optimal way to improve future behaviour. Legal and financial sanctions have a strong signaling function, as they clearly indicate that misconduct is not accepted. However, there also is a downside to such communications. For instance, the prospect of invoking severe disciplinary measures can prevent traders from voicing concerns about questionable business practices or makes them hide instead of reporting (beginning) misconduct of their teammates. Further, the imposition of (deterrence) sanctions generally undermines employee trust and reduces rule compliance (Mooijman *et al.*, 2015; Tenbrunsel & Messick, 1999).

Even though the increase of controls might have some preventive effects – in terms of decreasing opportunity for traders to behave unethically, and sending out a signal on what behaviour is risky – increasing controls alone is not enough. The same accounts for limiting geographical distance. Whilst geographical distance provides a challenge for effective oversight and controls of behaviours, it does not predict misconduct (i.e. there are also teams geographically distant from a Bank's head office that show excellent ethical conduct). Unethical behaviour is not solely determined by opportunity to behave poorly. Opportunity is about circumstance, not

about what actually drives unethical behaviour. However, the increase in controls by banks is in line with the regulatory increase and demands of financial supervision. The political environment pushes this development as well. All these rules, regulations and controls might contribute to a (short-term) decrease of misconduct, but are insufficiently effective by themselves to sustainably prevent unethical behaviour.

In sum, current responses to misconduct tend to be suboptimal, and can even be counterproductive. Yet containment, disciplinary and control strategies characterize the way banks deal with misconduct, and reflect the demands of regulators, supervisors, and politicians.

First attempts to prevent future misconduct

Next to the three-way reactive response to misconduct outlined above, banks do undertake some preventive measures with the aim to prevent future misconduct. First, many banks alter their incentive compensation (often the balance between fixed and variable income) and performance management systems, related to promotion and talent development. Next to qualitative targets and KPI's, qualitative and behavioural targets are added to performance assessments. These changes, some of which are enforced by regulators, aim to lower the motivation for taking excessive risks and relating success in these businesses solely to revenue.

A second preventive measure is the addition of integrity tests to recruitment and selection processes, to try and filter out 'bad apples' coming in. Additionally, in the Netherlands the banking employees are required to take a Bankers' oath¹¹. The objective of this oath, that is binding in the Netherlands for all banking employees, is to affirm ethical standards that provide guidance for integrity and individual behaviour and is a legal basis for later measures against breaches of these guidelines. Finally, as a preventive measure many banks embark on a trajectory for culture change that amongst other things emphasises professional integrity. An example is the Culture change program of Deutsche Bank AG¹² or the code of conduct of JP Morgan Chase¹³. Pushing integrity as a corporate value, and promoting an organizational culture that fosters ethical behaviour, is often one of the aim of culture change programs like these.

Even if well-intended, these preventive measures are insufficiently effective in actually preventing misconduct. There are two main reasons why this is the case. First, the measures generally do not target team level mechanisms. As a result, the direct social context of employees is in these preventive measures often not addressed.

¹¹ See for the Dutch Bankers' oath, that all banking employees are obligated to since January 2016: www.bankierseed.nl or www.nvb.nl. For the Banking and Finance oath, see: www.thebfo.org.

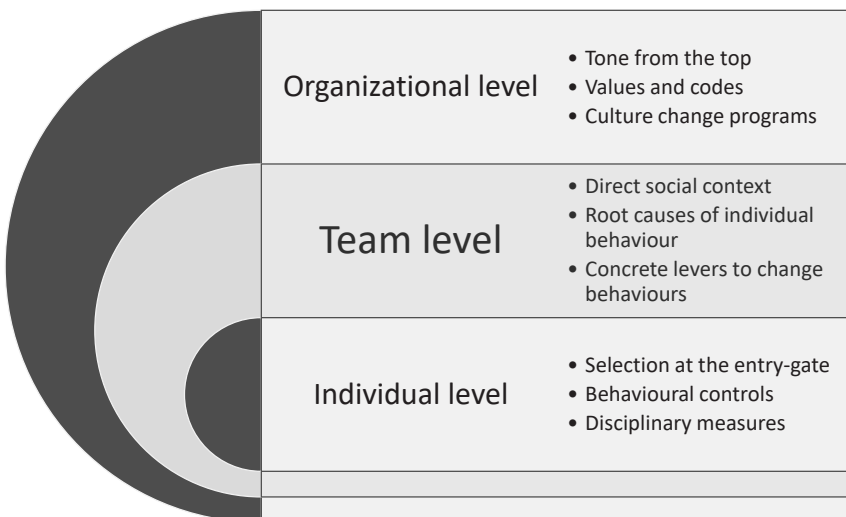
¹² <https://annualreport.deutsche-bank.com/2012/ar/deutschebankgroup/culture.html>

¹³ <https://www.jpmorganchase.com/corporate/About-JPMC/document/FINAL-2014CodeofConduct.pdf>

Changes in incentive compensation (such as a bonus cap) and performance management systems, integrity tests and a Banker's oath, all aim to impact the individual processes that underlie behaviour. Take for instance an integrity test: this instrument aims to test individual integrity outside the work context, and is not applied to groups of employees.

The teams these individuals work in are not sufficiently taken into account in these preventive measures. This is also the case for the culture change programs. These programs are often designed to change culture at organizational level. The explicit example given of the Deutsche Bank program, is a global program designed to change the culture of the whole bank (with its 98.000 employees, present in about 60 countries). Even if this is successful at an organizational level, it remains a challenge for banks of this size to translate their corporate values and culture change ambitions to their varied working floor contexts. This translation to working floor or team level is essential for achieving actual behavioural change on the working floor, and hence for the success of a culture change.

Figure 3.1. Individual, team and organizational levels, and their role in preventing misconduct by impacting behaviour and culture.



The second reason for the insufficient effectiveness of the preventive measures banks take, is that these measures are often detached from the core business. For example, culture change programs often stay at a generic level (with a focus on corporate values), and are insufficiently translated to the business of for instance a trading desk, or the performance targets individual workers are supposed to meet. For instance, employees are introduced to the corporate values and expected to be aware of the culture the bank wants to see. If these values are not translated to concrete guidelines that relate to team level realities, it may be unclear for a trader what day to day behaviour within his task is expected. The objective of the culture change, the culture the change program aims for, usually is not explicitly connected to the strategy of the bank nor is

it clear how the pursuit of culture change relates to the core business of each team. A generic integrity test or Banker's oath are also not connected to the task of an individual employee after he or she is employed. These instruments are context-free, and often convey very generic and unified guidelines even though their implications can be very different for traders, retail bankers, secretaries and other employees.

- *An illustrative example from supervisory practice (Nr. 11, see Table 2.1).*

A trader at a global significant bank uttered his confusion about the aim of the culture change program this bank was running. He wondered what was expected of him: "*Culture or profit*". In his perception, the behaviour that the culture program was promoting (like 'integrity') would also imply that he would make less profit. He thought 'good behaviour' also implies making less money. It was not clear to him how this culture change would profit the business goals. "*What do they want from me?*".

I argue for a preventive approach that does address culture at team level, and takes the business itself, the work task, into account. The next section presents this preventive approach, based on social psychological insights.

B. Preventing future misconduct: a social psychological perspective

Taking into account the contextual root causes of unethical behaviour will enhance the effectiveness of attempts to mitigate misconduct risk. Preventing future misconduct in this way requires that financial organizations and supervisors:

1. *Define* team climate: identify to what extent social psychological root causes may drive future misconduct within teams.
2. *Improve* team climate: target these social psychological root causes within teams.

This section gives a compressed introduction of the two-step approach that this social psychological research promotes. I will elaborate on this approach in further chapters: I will explore the scientific research that supports it, and report and discuss experiences and outcomes of the use of this two-step approach in financial supervision.

Step 1. Define team climates

The first step of the preventive approach is to define team climates to identify to what extent social psychological root causes may drive future misconduct. These root causes of misconduct occur at team level, harboured in team climate. Let's say a Fx trading desk in the City of a certain investment bank consists of 7 traders, including a desk manager. Behavioural patterns of this team, of these 7 traders, and the climate within this team, influence ethical behaviour of the individual traders who are part of this team. This approach explicitly addresses team level of analysis, since a trading team is the most relevant day-to-day social context for a trader. As stated above, research clearly shows that our professional ethical behaviour and the moral decisions we

make at work are strongly influenced by the work teams in which we function: our colleagues and managers (Kish-Gephart *et al.*, 2010). For instance, other group members establish a concrete standard for ethical behaviour through their actions and omissions. These provide information on social norms of acceptable behaviour, and indicate what is considered ethical and appropriate in this group context (Moore and Gino, 2013). This is why I propose to analyse team level concerns and behaviours as root causes of unethical behaviour of traders. Although this first step of the preventive approach is an analysis at team level, there are contextual organizational factors that this model proposes to take into account while identifying root causes of misconduct. These contextual factors refer to the three organizational aspects discussed in Chapter 2: a history of strong and fast growth of the businesses, a history of revenue as the main organizational goal, and a history of high pay or incentive compensation. These contextual factors should be taken into account when assessing climate and social psychological mechanisms within trading teams.

I present the ‘Corrupting Barrels Model’ to capture social psychological mechanisms that facilitate misconduct at team level (Scholten & Ellemers, 2016; see Figure 3.2). The title of the model – Corrupting barrels – refers to the teams that can harbour these root causes. As stated above, it is too simplistic to think of rogue traders only as bad apples spoiling the barrel. Applying a social psychological perspective clarifies that the barrel may also have corrupted these apples – and may do so again in the future. The model targets three core team characteristics that can contribute to misconduct addressing the way the team deals with its *task* (ineffective error approaches), interpersonal *relationships* within the team (outcome inequality), and the functionality of the team *climate* (dysfunctional moral climate):

1. *Ineffective error approaches (dealing with task)*

The first category addresses the way errors are managed within the trading team. Errors refer to all kinds of unintended failure. Error management addresses patterns in how a team deals with failure that is related to the task its performing. Three ineffective error approaches are taken into account: denial, empathy and blame-and- punish. These ineffective error approaches within a team can contribute to unethical behaviour of its members. It therefore harbours possible social psychological root causes of misconduct. Chapter 8, paragraph 8.1., elaborates on ineffective error approaches and their contribution to the occurrence and persistence of unethical behaviour at work.

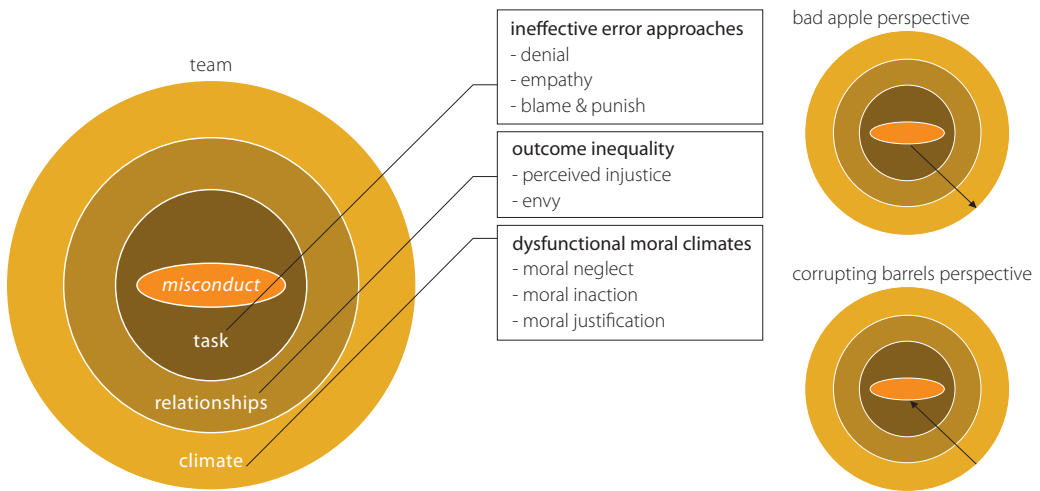
2. *Outcome inequality (interpersonal relationships)*

The second category addresses the unequal relationships within a team. This inequality can be present in relationships between team members or co-workers, and in relationships with management. It can lead to emotional consequences, such as perceived injustice and envy. These emotional consequences of unequal relationships within a team can contribute to unethical behaviour of its members. It therefore harbours possible social psychological root causes of misconduct. Chapter 8, paragraph 8.2., elaborates on outcome inequality, and its contribution to the occurrence and persistence of unethical behaviour at work.

3. Dysfunctional moral climate (team climate)

The third category addresses the moral climate within a team. Moral climate refers to the way the team deals with the moral dimension of its work. I address three aspects of moral climate: moral neglect, moral inaction and moral justification. The moral climate within a team can contribute to unethical behaviour of its members. It therefore harbours possible social psychological root causes of misconduct. Chapter 8, paragraph 8.3., elaborates on dysfunctional moral climates, and their contribution to the occurrence and persistence of unethical behaviour at work.

Figure 3.2. *The Corrupting Barrels model: social psychological root causes of misconduct at team level (Scholten & Ellemers, 2016).*



Step II. Improve team climates

The second step of the preventive approach of misconduct, that this social psychological research promotes, is to target these social psychological root causes by improving team climate. Specific improvements to team climates that facilitate unethical behaviour are to adopt a more effective error approach to task performance, to adapt treatment of individual workers and improving the moral climate. Based on the outcome of the identification in the first step of the preventive approach, team climate and detrimental behavioural patterns can be improved, and consequently prevent misconduct happening in the future.

This second step of the preventive approach presented here implies a great opportunity that has as yet not been seized: targeting and changing the social psychological root causes of misconduct that lie within team climates. The Corrupting Barrels model can be used to identify team level root causes of misconduct. The good news is that these root causes can be targeted by business areas within the bank. Financial supervision can require of banks to do so. This research aims to reveal the adjustments banks can make within team climates, in order to prevent future misconduct.

Embark on preventing misconduct, in addition to reacting to misconduct cases

Banks ought to embark on the preventive approach of misconduct, in addition to the reactive measures they take to deal with misconduct cases. It is fair to say that the preventive approach that I promote here has downsides, compared to the reactive banking approach. There are valid reasons why this approach has been neglected so far. First, the preventive approach is not aligned with the professional background of the people within this sector. The analysis of social psychological root causes within trading teams requires social psychological expertise, that is underrepresented among professionals in the banking context. Second, the preventive response to misconduct is less visible to the public and to society. It does not entail a law suit that a bank can win, with media attention to show as a bank how strongly it opposes misconduct. The preventive approach requires a thorough analysis – although this analysis is not more time consuming than a law suit - and then a change of team climate and social psychological patterns that requires continuous attention and a long-term perspective. It does not offer a quick fix.

However, there is much to win in embarking on the preventive approach presented here. It is a simple truth that to truly prevent misconduct, deeper insight in what caused prior misconduct is needed. This preventive approach reveals what root causes of misconduct are present in the direct social context of traders, their trading team. Behaviour is rooted in team practices and climate. When we are able to pinpoint these practices, investment banks can use them to influence the behaviour of the traders part of these teams. By making adjustments in team procedures and other aspects of the teams these traders work in, their individual behaviour can be influenced and guided where necessary. This research aims to reveal these insights and hand investment banking useful leverage points to make cultural and behavioural changes in trading and sales business teams, in order to prevent future misconduct. The application of social psychological insights regarding unethical behaviour to trading teams, to this specific professional context, has not been made before and is therefore unexplored. Social and organizational psychology and the banking sector have been worlds apart. The current times ask for these worlds to meet.

