Culture, Diversity and the Way Forward.
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Briefing note for the Panel Discussion in Session II
"Culture and Diversity: Evidence from the Field"

1.- The two corporate dimensions of culture and diversity

There is little doubt, to my mind, that (corporate) culture and (board) diversity are necessary, and interconnected, ingredients for a better corporate governance, for financial institutions in the first place. To me – and clearly this is only a too broad and rough classification - there are possibly two ways to look at their role in this context. Half-jokingly, I would describe them as an Old Testament view, and a New Testament view.

(a) The minimalist view.

First, the Old Testament view. Banks should embed a (corporate) culture made of values strong enough to prevent them from doing evil. In such a context, diversity at the level of professional NEDs is essential to make CEOs and controlling shareholder(s) less akin to kings, and non-executive directors more than just "their cheerleaders" (Stilpon Nestor, 2018). All-mighty persons are rarely divine, and often oppressive. This approach looks thus at culture and diversity as 'internal boundaries', 'breaks and balances' to tame (i) blunt profit-maximizing instincts and (ii) sheer self-interest of financial institutions and their agents. In this vein, a growing strand of literature, with evidence from the field of psychology, behavioural economics and cognitive neuroscience, finds that corporate cultural identity and beliefs matter within the organization and in the boardroom. They can take corporation to better build their relationships with the wide range of their stakeholders to prosper. If "humans" are more than just "econs", *a code of pre-committed values* can 'nudge' businesses, and financial institutions in the first place, towards a more values-oriented inspiration of both their internal organization and their activity. Corporate culture, and the ensuing cultural audits, should help in preventing excesses, in moderating the psychotic, artificial single-mindness of business corporations and their leaders as implacable "externalizing machines" (as Joel Bakan called them in 2005 (at p. 70), for they make third parties bear part of their costs while retaining all profits).

But the problem of (corporate) "culture" is its lack of definition. Culture is evocative, but, to be useful as an Old Testament guidance, it needs to be also "performative". This is an issue I will briefly touch upon later.

(b) The maximalist view

There can also be, though, a second and maximalist view. The New Testament calls for more than just limits; it requires a simple but not so obvious positive action: doing good. In this vein, corporate culture and board diversity (specifically where professional NEDs are expression of impact investors) may become more than breaks, and rather fundamental propellers for a different role of financial institutions. Lynn Stout - who too prematurely passed away last April and whom I deeply miss - called it the culture of a corporate governance for a privately-ordered public policy (Stout, Gramitto 2018). In her words, corporations can contribute "to solve collective social and economic problems", because they "control tens of trillions of dollars in assets and affects hundreds of millions of customers, employees and shareholders (…). The corporate sector can provide enormous benefits". This is particularly true, to my mind, for financial institutions (and development banks among them). In other terms, culture and diversity are not just limits; they could drive positive societal change. Yet, also in this maximalist context, no real change can credibly be expected absent any structured channels by which culture can turn into 'law', or at least 'law of the sort'.

2. How to make culture operational?

The question, then, is: how to make (corporate) culture truly operational? Both the Old and New Testament views are consequential, but each poses its own problems on how to answer this question. Even if we believe, as I do, that financial institutions, and the law of finance, are there for the common good, we should refrain from utopian wishful thinking. As Donald Langevoort nicely put it (2017, p. 947) "There is ample empirical evidence that strong corporate cultures can add economic value and are recognized as valuable assets by firm leaders. But self-interest hides, not disappears".

Then, what? To me different tools correspond to the two different philosophies sketched above.

3.- In the minimalist context, how to select and code cultural values and how to ensure consistency of action are (new) daunting tasks for chairs and independent directors.

The Old Testament, minimalist view places culture in a middle land between law and markets. Dan Awrey (2013, p. 191) was very clear on this: financial firms should make a deep commitment to both law and ethics and work hard to sustain their commitment. Interestingly, this is thought to require the "right tone from the top", and thus a top-down, hierarchical approach to corporate culture. Good examples and savvy instructions and processes should come from the CEO and from the board. Yet this is necessary but not enough. On one hand, a bottom-up cooperation is also needed to have culture really permeating the organization. On the other hand, building on social psychologist Tom Tyler's findings (2014, p. 267), the preferred normative strategy should be reliance on values-based internal codes rather than command and control rules. These "holy books" are necessary if, as Donald Langevoort again put it (at p. 947), boards and senior managers must become "evangelists for virtue".

Making operational this corporate culture is easier said than done. At a minimum, the chair and professional NEDs must take very seriously two tasks:

(a) to assess and monitor the behavioural traits of the CEO (something that may prove challenging, but never impossible: modern psychology shows clear "correlations between observable executive personality or cultural traits and firm-wide outcomes": Langevoort, p. 948) and his or her behavioural consistency with the corporate culture;

(b) to develop a credible, tailor-made (institution-specific), cultural code and monitor, through cultural audits, the actual commitment of the overall organization to it.

In both regards, compliance with culture is challenging on its own (Langevoort, 2017). It remains to be seen how, in due course, artificial intelligence and robotics (even at the level of the board, as we start to see in some Asiatic boards) would fare in redressing humans' complacency biases. For the time being for financial institutions an important stewardship role is taken up by financial supervisors, as Irish, British and Australian experiences seem to witness.

4.- *In the maximalist context, key is making cultural values part of the corporate goals by institutionalising what "makes the difference".*

As noted, the maximalist view goes well beyond of this. It looks at effective ways to 'nudge' financial institutions to achieve both private gains and public good, heralding a new ethics of moderation.

There may be fifty or more shades of gray of this New Testament corporate culture for the common good (as William Greiser noted in 2016). Some financial institutions incorporate this culture, albeit in a wide array of variations, into social and environmental sustainability principles for their business models and product design. Others commit to be fully-fledged socially responsible, impact investment firms. Some embark in microfinance or ethical banking. Altogether, this is not new; what is perhaps new is the contemporary narrative (consider to this effect e.g. UmweltBank in Germany, Triodos Bank in the Netherland, Banca Etica in Italy, Co-operative Banks in the United Kingdom, and some large 'conventional' banks, like CaixaBank in Spain). This seems to reflect what Mark Carney dubbed as "a new age of responsibility in banking and finance" (Kenadjian, Dombret 2016).

There is consensus that ethics and culture are key in rebuilding people's trust in the financial sector (the Group of Thirty and the FSB already made it clear few years ago)[1] and this may take a generation. But my point here is that, to have a step-change and re-build trust, New Testament 'values' need to be made operational, and this means that they need to be *institutionalized* (Kenadjian, 2016). Institutions help to bridge the gap between values and goals and to make corporate culture not just a fig leaf.

I make only one example taken from the field (not surprisingly, from Italy). Banca Prossima was established in Milan in 2007 as a subsidiary of the Intesa group (ISP) (Lamandini, Steiner, 2007). This bank focuses on inclusive banking. After 10 years of practice, the experiment looks successful and has recently driven the group to adopt a similar, but much larger scale, initiative of impact banking to become the most advanced experiment of impact banking worldwide. What is of interest here, is that this maximalist culture is enshrined in its articles of association. Under Italian company law, whilst profit seeking is a mandatory requirement, profit *maximisation* is not. The by-laws set out that disposable profits beyond a set amount annually paid out to shareholders with priority to reward the cost of capital, are allocated to *a special net assets provision which works as an internal guarantee fund.* There is no asset segregation for the fund, which is managed by the board of directors (the board must however consult with a special committee to this effect). Specifically, *w*hen the bank lends to borrowers whose credit scoring is below the threshold of eligibility (classes "R 4" and "R5", together constituting the so called loans' "portfolio Gamma") under usual credit standards, specific extra provisioning is made against the fund. This is meant to ensure that the fund can make good all realised losses from the Gamma portfolio. The provisioning against the fund is statistically calculated to prevent a misalignment between the fund's resources and the stock of insured portfolio Gamma. In other terms, the fund is such that it insures the additional risk for the bank associated with the difference in performance between the portfolio Gamma and the last class (R3) of eligible borrowers under usual credit scoring standards. In so doing, once such additional risk is covered by the fund, R4 and R5 borrowers can be treated, for credit eligibility, as if they were eligible borrowers. The increased risk associated to the portfolio Gamma is neutralised by the fund (on a rotative basis, with yearly computations) once the loss is realised, making good such losses (in net terms and to the extent

[1] Group of Thirty, *Banking Conduct and Culture (2015): A Call for Sustained and Comprehensive Reform,* at http://group30.org; FSB (2014), *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture* (at http:/www.fsb.org/2014/04/140407. For an insightful analysis, Raaijmakers, M. (ed) (2015), *Supervision of Behavior and Culture: Foundations, Practice & Future Developments,* De Nederlandsche Bank, Amsterdam.

the loss is attributable to the differential risk of portfolio Gamma). In this way the financial institution drives societal change through financial inclusion and, at the same time, reaches a much wider client base. It has measurable social impact and adopts a long view on value creation. The present use of part of the short-term profits is justified to internally subsidize social engagement and enlargement of the client base in view of the mid-to-long term returns associated, both in economical and reputational terms, to these investments.

Other examples could be made. Let me only mention the risk that massive NPLs foreclosure proceedings, in the absence of a homestead exemption, may convert into a significant cause of social unrest. Positive actions to support them in finding living alternatives and financial re-inclusion after delinquency must be adopted, also to alleviate the risk of backfire. All this builds on the idea that some positive action from financial institutions is necessary and corporate culture helps in identifying the right action for the right institution; in this culture becomes – again in the words of Lynn Stout – a fundamental instrument for "a private ordering as a third way superior to either free markets and regulation".

5.- Corporate culture and board selection.

Clearly, these New Testament experiments may invite all sort of arguments usually adopted against multi-stakeholder governance. Sacrificing (part of the annual) profits in the social interest is extremely controversial and 'benefit corporations', both in the US and in Italy, must still prove their case. They raise important questions, normative as well as positive. However, the maximalist approach to corporate culture for financial institutions also confirms that corporate governance for financial institution is somehow different from 'ordinary' corporations (Hopt, 2015). Prudential requirements, but also culture may call for a more composite and more effective board of directors.

A tentative normative question here is how to properly select those having the right culture to serve in the board. Shouldn't we start by asking NEDs' candidates to clearly spell out in advance their programs on corporate culture, so that competing values and goals can be assessed both ex ante and ex post? To take corporate culture seriously, accountability paves the way to legitimacy.