An Explanation for the Emerging Shift from Compliance Culture to Ethical Culture in the Financial Industry

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Abstract

Financial services are an important and influential sector of every economy, contributing significantly to global economic activity. A stable and sustainable financial sector is, therefore, critical for global economic growth and socio-economic development.

To explain the emerging shift from a compliance culture to an ethical culture in financial services, the study begins with a literature review of the corporate scandals involving Enron and WorldCom. Although Enron and WorldCom were not in the financial services sector and certainly not the first corporate failures, they marked the beginning of a period of significant regulatory reform by supervisors and regulators in response to ongoing systemic and corporate failures.

The study continues its literature review of how, despite regulatory efforts to prevent future scandals and losses through reforms, the financial services sector’s conduct has remained largely unchanged. Financial institutions' sole focus on profit, distorted incentives for bankers, and regulators' restrictive and narrow approach to reforms have all contributed to the state of the sector.

In order to deal with the restrictive reforms, the study reviews how financial institutions developed sophisticated compliance programmes designed to mitigate the risk of regulatory sanction and reputational harm. The compliance culture that evolved within these institutions proved ineffective, resulting in significant unintended consequences and an inability to adequately address poor governance and prevent corporate failures in a sustainable way. The study examines these inefficiencies, their effects, and how regulators proposed addressing the compliance culture's 'dark side'.

The study further explains the motivations for the emerging shift from a compliance culture to an ethical culture against the background of how regulators and industry groups have started to call on the financial services industry to reconsider its approach and embrace an ethical culture. The study finds that regulatory frameworks alone are insufficient to address the sector's unethical practices, and approaches that promote ethical behaviour of financial institutions are necessary. In conclusion, this study considers the advantages for organisations that make the transformation to an ethical culture.

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Opsomming

Finansiële dienste is 'n belangrike en invloedryke sektor van elke ekonomie, wat aansienlik bydra tot globale ekonomiese aktiwiteit. ’n Stabiele en volhoubare finansiële dienste sektor is daarom van kritieke belang vir globale ekonomiese groei en sosio-ekonomiese ontwikkeling.

Om die ontluikende verskuiwing van 'n voldoeningskultuur na 'n etiese kultuur te verduidelik, begin die studie met 'n literatuuroorsig van die korporatiewe skandale waarby Enron en WorldCom betrokke was. Alhoewel Enron en WorldCom nie in die finansiëledienste sektor en ook nie die eerste korporatiewe mislukkings was nie, was dit egter die begin van 'n tydperk van beduidende regulatoriese hervorming deur toesighouers en reguleerders in reaksie op voortdurende sistemiese en korporatiewe mislukkings.

Die studie gaan voort met ‘n literatuuroorsig van hoe, ten spyte van regulatoriese pogings om toekomstige skandale en verliese deur hierdie hervormings te voorkom, die finansiële dienste sektor se gedrag grootliks onveranderd gebly het. Finansiële instellings se uitsluitlike fokus op wins, verwronge aansporings vir bankiers, en reguleerders se beperkende en eng benadering tot hervormings het alles bygedra tot die toestand van die sektor.

Om hierdie beperkende hervormings te hanteer, ondersoek die studie die gesofistikeerde nakomingsprogramme wat finansiële instellings ontwikkel het om die risiko van regulatoriese sanksies en reputasieskade te beperk. Die voldoeningskultuur wat binne hierdie instellings ontwikkel het, blyk ondoeltreffend te wees en het gelei tot beduidende onbedoelde gevolge. Hierdie studie ondersoek verder hierdie ondoeltreffendheid, die uitwerking daarvan en hoe reguleerders voorgestel het om die nakomingskultuur se 'donker kant' aan te spreek.

Die studie bied ‘n verduideliking vir die motiverings agter die ontluikende verskuiwing van 'n voldoeningskultuur na 'n etiese kultuur aan teen die agtergrond van reguleerders en bedryfsgroepe wat 'n beroep op die finansiëledienste sektor begin doen het om sy benadering te heroorweeg en 'n etiese kultuur te omhels. Die studie bevind gevolglik dat aangesien regulatoriese raamwerke, alleen, onvoldoende blyk te wees, is benaderings nodig wat finansiële instellings se etiese kultuur bevorder. Ten slotte verken die studie ook die voordele vir organisasies wat die verskuiwing na ‘n etiese kultuur sou maak.

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1. Chapter One – Introduction

1.1 Background

Corporate scandals have been common since the turn of the previous century. Danat-Bank, Germany's second-largest bank, failed in 1931 due to excessive risk-taking (Schnabel, 2004). Jensen (2015) investigated how American-made cars made in the 1960s were unsafe to drive at almost any speed. According to The Economist (2019), massive tobacco and asbestos lawsuits were filed against US corporations in the 1990s. Ball (2009) added to this list by publishing research on the Enron, Arthur Andersen, and WorldCom accounting scandals of the early 2000s.

In response to the Enron and WorldCom corporate scandals, legislators introduced significant regulatory reform. In 2002, the US Congress passed the Sarbanes-Oxley Act (SOX) to restore investor confidence in the US capital markets. In their in-depth analysis, Primbs and Wang (2016) explained how SOX introduced several regulatory reforms aimed specifically at corporate reporting and accounting in an attempt to prevent future governance failures. Regulators had no idea that their reform efforts were only addressing the tip of the iceberg.

Enron and WorldCom were relatively minor corporate failures compared to the massive systemic 2008 financial crisis. Most of the crisis's early scandals involved financial institutions, specifically investment banks. The collapse of Lehman Brothers Bank in September 2008 started a chain reaction that brought the world's financial system to its knees. According to Blundell-Wignall *et al*. (2008), other banks such as Merrill Lynch, CitiBank, and Bear Stearns were all exposed as prominent players in exploiting incentives created by Basel I and the Security Exchange Commission (SEC) rule changes of 2004. The subsequent credit crunch plunged the world into its worst recession in 80 years (Antonopoulou, 2010). The aftershocks of the 2008 financial crisis are still reverberating throughout the global economy more than a decade later.

When the origins of the global financial crisis were traced back, it became clear that the crisis had multiple causes (Ramskogler, 2015). However, the most apparent were the bankers themselves – particularly the greedy types who believed they had

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discovered a way to eliminate risk. The bankers, though, were not the only ones to blame. Legislators, regulators, and central bankers were equally responsible for the crisis. Their complacency tolerated reckless borrowing and excessive risk-taking by financial institutions (The Economist, 2013). The Financial Crisis Inquiry Commission (2011), established by the US Congress to investigate the causes of the financial crisis, concluded in its report that the financial system's own failures significantly contributed to the situation. The Commission's report highlighted widespread failures in financial regulation and supervision frameworks that were supposed to minimise the risks of systemic failures.

In response to the global financial crisis, legislators in the US introduced the Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act in 2010. The Dodd-Frank Act was specifically introduced to increase financial stability and prevent future financial crises from causing systemic destruction. Dodd-Frank established, amongst others, the Consumer Financial Protection Bureau (CFPB), raised capital and other prudential requirements, and expanded oversight of the financial services sector. According to Baily, Klein, and Shardin (2017), Dodd-Frank has had many positive effects. However, legislators soon realised that balancing long-term sustainable growth and financial stability for such comprehensive systemic reforms is a long-term objective and cannot be achieved overnight.

Despite far-reaching and pervasive regulatory reforms such as SOX and Dodd-Frank, little fundamentally changed in the financial services sector since the financial crisis. History seems to continue repeating itself. By 2015, instances of serious misconduct involving financial institutions in the US and Europe had dominated global headlines. In 2012, Barclays Plc, one of the world's largest banks, admitted to manipulating the London Inter-Bank Offered Rate (LIBOR) (McBride, 2016). Several other banks admitted to similar behaviour over the following three years. Even more corporate scandals followed, including Barclays Plc and other international banks' gold and silver price-fixing offences (Slater & Jones, 2014), Wells Fargo's fake account misdeeds in 2016 (Tayan, 2019), the US Bancorp money-laundering control failures (Schroeder, 2018), Australian banks' fee scandal (Schroeder 2019), and the Danske Bank money-laundering (Jensen, 2018).

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In South Africa, corporate scandals involving VBS Mutual in 2018 and African Bank in 2014, rocked a country plagued by corruption and mismanagement. The South African banking sector is highly regulated. However, the evidence presented at the Judicial Commission of Inquiry into State Capture revealed questionable behaviour by at least two of the country's largest banks. According to Van Vuuren (2020), Nedbank will face serious questions about its relationship with the Bank of Baroda, which allegedly had business relationships with the infamous Gupta family. Standard Bank will also have to explain how it missed major red flags involving suspicious account activity of Gupta-related companies. The fact that banks keep finding themselves in such situations – despite being heavily regulated by the Financial Sector Regulations Act (including twelve other financial service-related acts), which subscribes to the King IV Report on Corporate Governance – remains a topic worthy of investigation, and one of ongoing global concern.

Globally, legislators and regulators hoped that regulatory reforms would address the mindset of short-term oriented performance and self-enrichment, which had been identified as one of the primary causes of the financial crises. Many of these multi-national corporate scandals revealed how even the best regulatory frameworks failed, whether due to leaders' self-centred behaviour, bad corporate culture, or an over-reliance on so-called gatekeepers such as compliance officers and auditors. This lack of fundamental change begs the question of whether there is a broader issue to blame for the financial sector's inability to transform adequately. Let us consider some possible causes.

According to Donaldson (1989), the barriers to transformation are not in the nature of people or businesses but rather in attitudes. People's attitudes shape their habits and behaviours, which in turn influence the culture of their organisations. The G30 Working Group (2015:17), which examined the events that precipitated the 2008 global financial crisis and subsequent events, concluded in its report that the lack of good organisational culture played a significant role in the crisis. The G30 Working Group suggested that a substantial improvement in bank culture is a matter of economic necessity and corporate sustainability. Moreover, it is imperative for restoring society's trust. The G30 Working Group (2015:11) identified "poor cultural foundations" and "other significant cultural failures" that contributed to the crisis.

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According to the report, unhealthy cultural norms or subcultures, which frequently include criminal behaviour, have caused considerable reputational damage to these institutions and harmed public trust. To gain better insight into this phenomenon, I will explore the concept of organisational culture in more detail.

1.2 Organisational Culture

The concept of 'organisational culture' appears to be ill-defined with no universal consensus on its meaning. To deduce a concept's meaning, Rossouw (2014) proposes a recognised conceptual analysis technique beginning with how a term or concept is commonly used in practice. However, the concept of organisational culture is currently employed in a variety of contexts. Even though there is no universally accepted definition of corporate culture, scholars have attempted to explain it in the context of business management.

Deal and Kennedy (1988:4) simply define organisational culture as “the way we do things around here”, whereas Kets de Vries (2001:205) explains it as a “mosaic of underlying assumptions represented as ideas, values, and typical patterns of behaviour ... it is like an invisible hand that organises things”. Robbins and Coulter (2005) describe organisational culture as values, beliefs, or perceptions that employees share in an organisation while Schein (2010:18) adds that it is a pattern of shared basic assumptions that the group learnt as it solved its problems of “external adaptation and internal integration”. Lastly, Rossouw and Van Vuuren (2017:247) define organisational culture as representing “a socially created shared mindset that sets norms for behaviour”.

These descriptions imply that culture is something distinct to the identity and behaviour of an organisation. As it is rooted in an organisation's identity, culture influences attitudes and establishes behavioural norms for workers in their day-to-day business situations. However, organisation culture can either be ethically sound or ethically rotten.

Sims and Brinkmann (2003:254) argue that there is no better example of a rotten culture hidden behind a 'glossy façade' of good governance than the infamous Enron case. Many people were perplexed as to how these behaviours had gone unnoticed

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for so long. All of the necessary controls for corporate social responsibility and good governance appeared to be in place. However, as the evidence unfolded, it became clear that these governance arrangements were essentially “window dressing” (Sims and Brinkmann, 2003:254). Behind the façade, the authors depicted widespread ethical corrosion or a lack of an authentic ethics dimension before the company's demise.

Coleman (2013) believes each organisation’s culture is unique, and various factors go into building one. However, one common characteristic for the foundation of a healthy culture is the organisation’s ethical values or the ethical dimension of its culture.

1.3 The Ethics Dimension

Enron had a distinct corporate culture. Leaders publicly promoted a culture of innovation, ethics, and hard work. What they actively encouraged and rewarded, on the other hand, had little ethical significance. Executives' actions fuelled a culture of greed, arrogance, and dishonesty that permeated all aspects of the company's operations. Enron's culture was, therefore, distinct albeit in a negative way. It lacked a critical component that makes for a good corporate culture – the ethical dimension.

The ethical dimension of organisational culture, according to Rossouw and Van Vuuren (2017:248), is defined as "matters of ethical significance in an organisation and what passes for norms, or ethically acceptable standards of behaviour". Enron's culture certainly did not meet this criterion. The question, then, revolves around how Enron managed to maintain a façade of good governance. Rossouw and Van Vuuren (2017:248) provide insights into how ethics was managed in a 'reactive mode' at Enron. Managing ethics in a reactive mode implies that the company had all the codes of conduct, regulatory compliance frameworks, and ethics artefacts in place. However, it only created a semblance of ethical commitment. No wonder Sims and Brinkmann (2003:254) describe "Enron Ethics" as "window-dressing ethics with talking instead of walking and ethics as rhetoric."

Enron was undoubtedly not the first or last corporate failure lacking an ethical dimension to their culture. Almost 13 years later, the G30 Working Group (2015), in

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their report on events that caused the global financial crisis, found that there were systemic weaknesses in embedding ethical values in financial institutions at the epicentre of the crisis. The report suggested that for the industry to transform in an economically viable way, it must achieve greater success in internalising the ethical dimension in its culture. The challenge, however, appears to be institutions' ability to identify and manage behaviour in grey areas where adherence to conduct principles and standards is a matter of moral judgement, rather than the mere ticking of compliance boxes.

The G30 Working Group (2015) further recommended that financial institutions would have to define the target culture unique to their identity as part of the more meaningful shift to an ethical culture.

1.4 Rationale, Objective and Approach of the Study

Corporate failures in the financial services sector is not a novel phenomenon. Many studies have investigated the causes of these corporate failures and have extensively discussed them (Grove et al., 2011; Essen et al., 2013; Tao & Hutchinson, 2013). These studies examined the effectiveness of risk controls and governance in corporate failures. However, it remains unclear why corporations fail to transform despite the implementation of compliance frameworks and strict regulatory oversight, and what possible solutions for preventing corporate failures could be. Recent studies on corporate culture have emphasised the importance of an ethical culture for long-term organisational success. Even though some companies have successfully made the transition, there are still calls for the larger financial services sector to transform and adopt an ethical culture.

The objective of this study is to add to this important discussion by explaining the emerging shift towards an ethical culture as a step towards sustainable transformation in the financial sector. The study has three objectives: first, to review existing literature to illustrate in Chapter Two that, in response to corporate failures, regulators introduced wide-ranging regulatory reforms with stringent regulatory compliance regimes to prevent these failures from recurring. Secondly, the study will demonstrate in Chapter Three that the measures put in place by regulators to prevent such occurrences were flawed and led to significant unintended consequences.

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Thirdly, this study will provide an explanation in Chapter Four for the emerging shift from a compliance culture to an ethical organisational culture and the motivations behind such a shift. Lastly, this study will conclude in Chapter Five with an explanation of how this shift may constitute a catalyst for more financial institutions to transform and cultivate ethical organisational cultures.

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2. Chapter Two – Regulatory Responses to Corporate Failures

2.1 Introduction

Through a review of existing literature, my objective in this chapter is to demonstrate that – in response to corporate failures – regulators introduced extensive regulatory reforms with strict compliance regimes to prevent such failures from occurring again.

Although not financial institutions, the Enron and WorldCom scandals were the catalyst for supervisors and regulators to intervene and refocus on governance for all corporates - with particular impact on the financial sector. The background and causes of these two corporate failures will be briefly discussed. I will further examine SOX's primary objectives as a regulatory response to restoring investor confidence in US capital markets, and then demonstrate how (despite the new regulatory landscape) the 2008 global financial crisis revealed how financial institutions exploited regulatory loopholes.

I will indicate how legislators responded by introducing the Dodd-Frank Wall Street Reform Act, which aimed to improve financial stability and prevent future financial crises. The Eurozone was not immune to the 2008 global financial crisis and how the underlying fault lines in its regulatory framework were revealed during the sovereign debt crisis of EU members. European central banks initially followed the lead of the US Federal Reserve, but later changed course and imposed severe austerity measures on Eurozone members with high sovereign debt levels.

I will conclude the chapter with a discussion illustrating how the South African financial services industry has had its fair share of corporate scandals, including how African Bank and VBS Bank failed due to corruption and bad governance. Nedbank and Standard Bank were singled out as facing serious questions about their ineffective financial controls during the decade of state capture from 2009 to 2018. While not directly responding to corporate scandals, South African legislators anticipated international regulatory developments and introduced amendments to local legislation.

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In summary, I will discuss how – in the wake of major corporate scandals – questions are raised about the effectiveness of regulatory frameworks and how legislators and regulators respond by introducing even more regulatory reform. This chapter aims to lay the foundation for a discussion of why history keeps repeating itself, and why more regulatory reform appears to be ineffective in transforming the sector.

2.2 Corporate Failures and Regulatory Reform

2.2.1 Enron and WorldCom

The economic boom in the US in the late 1990s was marked by an expansion strategy that raised corporations' performance expectations. How Enron and WorldCom dealt with these expectations, though, made them infamous.

The name 'Enron' immediately evokes images of massive scale corruption (Sims and Brinkmann, 2003). However, until its demise in 2001, Enron was hailed as the epitome of corporate social responsibility and integrity. It was portrayed as successful, forward-thinking, charitable, and environmentally conscious. Enron essentially represented the best of what a modern-day organisation had to offer in terms of finances, social responsibility, and corporate ethics.

Considering this, one cannot help but wonder how it is possible that an organisation that was initially perceived as an exemplar of good corporate citizenship now serves as a case study for greed and corruption. According to Sims and Brinkmann (2003:254), a "glossy façade" of cultural artefacts like ethics policies and codes of conduct concealed a deeply flawed leadership culture that significantly contributed – and ultimately led – to Enron's collapse.

This rotten culture was, of course, aided by flaws in governance oversight frameworks; not least on the part of Enron's board, audit committee, and its external auditor at the time, Arthur Anderson. Lawmakers in the House Energy and Commerce Committee's investigations panel questioned how these behaviours could have gone undetected for so long given the company's multitude of gatekeepers. According to Sims and Brinkmann (2003:254), as the evidence unfolded, it became clear that these governance oversight frameworks were mere "window dressing" and lacked discernible substance.

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Another major corporate failure exposed in 2002 was the WorldCom scandal. WorldCom, the second-largest telephone company in the US at the time, was embroiled in an accounting scandal in which senior executives – led by founder and CEO, Bernard Ebbers – overstated the company's assets by more than $11 billion in order to maintain its stock price.

Thornburgh's (2003) investigation into WorldCom revealed a lack – and in some cases, non-existence – of corporate governance protocols. Due to a lack of internal controls, manual adjustments in the company's financial system were permitted without raising any governance red flags, thereby reducing the possibility of detection by compliance frameworks. Inadequate compliance and governance controls created numerous opportunities for misconduct, which were frequently worsened by pressure from Ebbers and other executives. This culture in WorldCom was unsurprising, given Ebbers' infamous description of the company's code of conduct as a "colossal waste of time" (Beresford, Katzenbach & Rogers, 2003:19). These circumstances created the perfect storm for a corporate scandal.

Besides Enron and WorldCom, corporate bankruptcies continued in 2002, establishing a three-year period during which US bankruptcies (the most severe form of corporate failure) broke all previous records (Smith & Walter, 2006). Massive pressure began to mount on the US Congress, central banks, and regulators to stem financial losses and implement measures to prevent economic devastation.

2.2.2 Regulatory Response to Enron and WorldCom

Shortly after the Enron scandal broke, congressional committees launched investigations and began to consider major legislative reform. Federal and state government officials, legislators, and enforcement agencies began to almost compete in their desire to clean up corporate abuses and excesses as a means of restoring trust in financial markets. The demise of WorldCom in the wake of the Enron scandal accelerated the pace of these proposals.

To investigate the massive corporate failures, the Justice Department established a Corporate Fraud Task Force in July 2002, which included a separate Enron Task Force. With these initial steps in place, Congress, the Justice Department, and the

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Securities and Exchange Commission (SEC) began cleaning up the trail of destruction left by the Enron and WorldCom corporate failures (Smith & Walter, 2006).

In a significant step, US Congress passed SOX in July 2002, in an attempt to reform corporate accounting and governance. The New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotations (NASDAQ) tightened their listing requirements around the same time that SOX was enacted. According to Smith and Walter (2006), SOX was the most comprehensive federal securities legislation enacted since the 1930s. SOX was so extensive, in fact, that the SEC had to draft several additional rules to ensure its implementation.

SOX introduced sweeping regulatory reform in several areas. In response to Enron's governance failures, it introduced significant changes to the accounting profession's accuracy, reliability, and transparency standards. SOX also imposed additional disclosure and financial reporting requirements on businesses, as well as measures to reduce conflicts of interest for directors and auditors. It gave the SEC more enforcement power and imposed personal liability for senior executives. As an indictment on Enron, SOX introduced regulations in the form of best practices to prevent window-dressing compliance (Primbs & Wang, 2016).

An aspect that made the Enron scandal an example in many business studies is the fact that even its external auditors were part of the cover-up. Primbs and Wang (2016:28) argue that one of Enron's most egregious governance flaws was the failure of its so-called ‘gatekeepers’. Enron's auditor, Arthur Andersen, failed to detect large-scale creative accounting practices. In fact, by signing off on financial filings, Arthur Anderson explicitly approved these questionable accounting practices. To address this, SOX established the Public Company Accounting Oversight Board (PCAOB) to oversee audits of public companies. Accounting firms that prepared audit reports for issuers, brokers, and dealers were required to register with the PCAOB. The PCAOB's responsibilities included establishing general auditing, quality control, and independence standards for these audit firms, as well as investigating and disciplining errant members (Public Company Accounting Oversight Board, 2002).

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SOX introduced measures to prohibit auditors from contemporaneously providing non-audit services for their clients in order to address auditor independence and accountability further. It also required publicly traded companies to rotate lead auditing firms every five fiscal years. These provisions were intended to strengthen auditors' roles as gatekeepers who are trusted to provide independent assurance to stakeholders about the financial position of publicly traded companies (Primbs & Wang 2016:29).

A major deficiency that was identified during investigations into corporate scandals was inadequate reporting. SOX aimed to ensure accurate reporting of information by compelling CEOs and CFOs to personally certify both financial and non-financial information filed with the SEC. Executives who fail to do so risk personal liability and criminal charges, which can result in fines of up to $1 million and imprisonment for up to 10 years, even if they mistakenly file inaccurate reports (Burrows, 2008).

SOX also imposed new reporting requirements on publicly traded companies. Powers, Troubh and Winokur (2002:192) found that one of the failures uncovered at Enron was that, while financial information was generally included in SEC filings, the company hid material information in report footnotes. In addition to the requirement for companies to improve their financial reporting, SOX compelled them to disclose information about other governance mechanisms such as codes of ethics and audit committee reports. Companies were required to disclose whether or not they had an audit committee, whether or not the audit committee included a financial expert, the expert's name, and whether or not the expert was independent of the company. Similarly, the company was required to disclose whether it had adopted an ethics code for its executives. If the company did not have a code, if it amended the code, or if its executives were exempted from the code, it was required to explain the reasons to the SEC in its filings.

After nearly two decades, the effects of SOX implementation are still being played out in the US media and courts of law. There is almost weekly news related to a publicly-traded company being served with a subpoena or settling charges with regulators. Whether SOX succeeded in reforming corporate accounting practices and restoring integrity to US financial markets still seems to be a matter of debate. Primbs and Wang (2016) suggest that while it can be argued that SOX only

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addressed the symptoms of corporate failures and simply shifted the financial sector from a system of self-regulation to increased governmental regulation, it undoubtedly refocused attention on transparency. In this regard, Primbs and Wang (2016) argue that SOX could be considered a success. However, it remains to be seen whether the SOX-led regulatory reform could not merely be considered a precursor to a much larger global regulatory response to a crisis that would push the global banking system to the brink of collapse.

2.2.3 The Global Financial Crisis

The global financial crisis of 2008 was arguably the most significant global economic collapse in modern history. Before the COVID-19 recession, economists regarded it as the worst financial crisis since the Great Depression (Gopinath, 2020).

The combination of banks' excessive risk-taking, speculative activity in financial markets, the availability of cheap credit, and the bursting of the US housing bubble caused the values of mortgage-backed guarantees to plummet and triggered a "classic 19th-century-style bank run" (Ramskogler, 2015:48)

Although the crisis had been building for a long time, its effects did not become apparent until September 2008. Lehman Brothers, a Wall Street investment bank and global financial behemoth, went bankrupt in just a few weeks. American International Group (AIG), Merrill Lynch, Freddie Mac, Fannie Mae, Fortis, and the Royal Bank of Scotland all faced liquidity crises and had to rely on central banks for assistance. It is estimated that £90 billion was wiped off the bottom lines of the UK's largest financial institutions in a single day (The Guardian, 2008).

The crisis struck the US investment banking and financial system first, then spread to Western Europe where sovereign debt risks sparked a second wave. The European sovereign debt crisis quickly spread among member countries with high government debt and institutional failures. Ireland's economy was the first to collapse. However, Greece's inability to repay its sovereign debt led to the collapse of other European economies such as Portugal, Cyprus, and Spain (Corporate Finance Institute, 2015).

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This leads one to questioning whether the start of the global financial crisis could be attributed solely to greedy bankers in the United States. The global financial crisis, according to Kono (2009), revealed structural flaws in international standards and best practices for prudential regulation and supervision. Blundell-Wignall *et al*. (2008) provided further insight into the systemic risks uncovered by the global financial crisis. They argue that global macroeconomic policies that affected liquidity in international markets, as well as weak regulatory frameworks, significantly contributed to the crisis resulting in massive economic destruction worldwide.

2.2.4 Regulatory Response to the Global Financial Crisis

Central banks initially responded by providing massive bailouts, also known as quantitative easing (QE). This unconventional mechanism entailed large-scale asset purchases by central banks, resulting in a significant increase in the US Federal Reserve's balance sheet. To keep the financial system from collapsing completely, European central banks pumped billions of euros into troubled financial institutions (Williamson, 2017). By 2010, QE in Europe had been largely abandoned in favour of harsh austerity measures imposed on the Eurozone's distressed economies (Newton, 2021).

Back in the US, the financial crisis forced a significant structural reform of the financial regulatory framework. Dodd-Frank was enacted to improve financial stability and prevent future economic destruction. Higher capital prudential standards and additional capital requirements for US bank holding companies were among the major reforms.

Dodd-Frank established the Consumer Financial Protection Bureau (CFPB), which increased oversight of financial institutions and established new regulatory procedures for safely winding down financial institutions. The creation of the CFPB significantly improved consumer protection mechanisms by consolidating the oversight responsibilities of seven different agencies with a unified focus. Dodd-Frank also brought previously unregulated derivatives exchanges and clearing houses into the regulatory net, effectively closing all previous regulatory gaps.

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Baily, Klein and Shardin (2017) hold that although Dodd-Frank has achieved many positives in terms of economic growth and financial stability, the financial crisis exposed significant flaws in regulatory supervision and oversight frameworks. The Financial Crisis Inquiry Commission (FCIC, 2011) stated that the financial system's own failures contributed significantly to the financial crisis. The report found that regulators had ample powers in many areas but chose not to use them. Former Federal Reserve Chairman, Alan Greenspan, relied on the widely held belief in the self-correcting nature of markets and the ability of financial institutions to self-regulate. As a result, the report concluded that the crises could have been avoided.

Another example that strengthens the argument that the crisis could have been avoided is that early warning signs of rising subprime mortgage default rates already emerged in 2006. In March 2007, the Institute of International Finance (which represented the world's major banks) emphasised the need to improve liquidity risk management. Around the same time, the Organisation for Economic Cooperation and Development, the Financial Services Authority, the International Monetary Fund, the Bank for International Settlements, and the Bank of England issued warnings about the increasing risk of subprime mortgage default rates.

Financial institutions, however, reacted with mixed and troubling responses. One such an example was the executives of Northern Rock who admitted to a parliamentary committee of inquiry after the crisis that they had read the Bank of England's Financial Stability Report and the Financial Services Authority's warnings about liquidity risk. Still, they deemed their model of raising short-term finance sufficiently sound.

In Europe, the global financial crises were not the only cause of the subsequent sovereign debt crisis. Fiscal structural issues such as a single currency and excessive deficit spending paved the way for the ensuing Eurozone crisis. In times of financial distress, countries often devalue their currency to boost exports to deal with fiscal risks (Corporate Finance Institute, 2015). In depreciating their currency in the period leading up to the global financial crisis, the Eurozone would have increased existing sovereign debt borrowed in US dollars and inadvertently contributed to the financial crisis. As a result, the EU's response to the crisis was primarily focused on addressing the high budget deficits. Members of the Eurozone

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who requested bailouts were required to implement severe austerity measures or government policies as a means of reducing public sector debt.

On the regulatory front, the European Central Bank (ECB) and European leaders proposed that the ECB become a banking regulator and oversee a deposit insurance program to supplement individual national programs. Basel II's effects – particularly the Capital Requirements Directive – were criticised because they forced European banks to rely on standardised assessments of only two private US firms: Moody's and Standard & Poor's (Ewing, 2012). In response, the European Supervisory Authority established the European Securities and Markets Authority, which became the EU's single credit-ratings agency regulator.

Although the global financial crisis had the most significant impact on the US, Europe, and other developed markets, it also impacted many developing economies. South Africa was one of the markets that experienced indirect effects of the crisis.

2.2.5 Regulatory Reform in South Africa

South African regulatory reform was ironically not a direct result of corporate failures or the global financial crises. Its financial system, particularly its banking system, was more protected than other developing countries and thus performed relatively well during and after the crisis.

Schmulow (2017) highlights that, while South Africa's regulatory reforms were grounded in normative goals highlighting the South African government's developmental priorities, it was also notable that South Africa took to heart lessons learned from other economies' failures to avert or deal with the financial crisis.

The regulatory reform in South Africa coincided with the regulatory intervention in the US shortly after the global financial crisis. It is no surprise, then, that South Africa's government stated that one of the guiding principles for a new regulatory framework should be that market conduct oversight be strong enough to support prudential regulation, particularly for systemic risks in the banking sector (Schmulow 2017:2).

With this mandate in mind, the Twin Peaks regulatory structure was implemented in 2011 with the publication of a National Treasury policy document. The policy

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document provided an overview of the financial sector and proposed overarching principles to guide whether – and to what extent – regulatory reform was required.

The Twin Peaks regulatory model was first adopted in Australia in 1997; followed by the Netherlands, Belgium, New Zealand, and the UK. Taylor (1995) explained that in the UK, Twin Peaks attempted to address primarily two issues: first, the disparate number of financial services regulators (each with their own limited jurisdiction) which left consumers confused as to whom to approach for assistance. Secondly, the blurring of the boundaries between different types of financial service providers – banks combining with insurers, and merchant banks combining with securities traders. These combinations of providers exposed gaps in regulatory coverage and resulted in inefficient supervisory frameworks.

To deal with these gaps in coverage, the Twin Peaks model envisaged the overarching Financial Sector Regulation Act (FSR Act) in South Africa, with the key objectives of promoting confidence in the financial system, financial stability, the soundness of financial institutions, and the financial sector transformation. The FSR Act (signed into law in August 2017) established two regulators: the Financial Sector Conduct Authority (FSCA), and the Prudential Authority (PA).

The FSCA would focus on enhancing financial market efficiency, integrity, customer protection, financial education and literacy. In contrast, the PA would promote the safety, soundness, and resilience of financial institutions. Although the two supervisors' jurisdictions differ, financial institutions had to prepare themselves for close collaboration and attention from the two regulators. Savage, Le Roux and Anley (2016) argued that this structure primarily addressed historical gaps in regulatory coverage. By adopting the Twin Peaks regulatory model, South Africa expected its new regulatory framework to provide adequate safeguards against corporate failures and future financial crises.

Although not directly in response to the global financial crisis, the King Reports on Corporate Governance followed an evolutionary process in South Africa. Corporate governance is a relatively new discipline that constantly evolves to meet emerging challenges and the increasing demands of corporates (Ramalho, 2020). Starting with

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King I in 1994, several iterations culminated in the publication of the King IV report in 2016.

The King Reports focused on establishing and recommending corporate governance standards for South African public and private sector institutions. Unlike other governance codes such as SOX, the King Reports are voluntary and are based on outcomes, principles, and practices. However, as South African law and jurisprudence evolved, the principles recommended in the King Reports were codified in the Companies Act of 2008, sections of the Public Finance Management Act, and the Promotion of Access to Information Act.

The introduction of the Twin Peaks regulatory model and the King IV governance code came at a good time. South Africa's financial regulatory reform was in line with the global regulatory reform, and it would further entrench the country's reputation as having a robust and stable banking sector. As with international regulatory reform, the question remains whether the regulatory model will be able to successfully avert future corporate scandals and failures.

2.2.6 Closing thoughts

Supervisors and regulators believed that extensive regulatory reforms would address and prevent another global financial crisis. The Global Financial Development Report (2020:1) showed how countries – at an international level through G-20 directives – introduced standards to promote the development and implementation of effective regulatory, supervisory, and other financial sector policies to prevent economic destruction.

However, whether regulatory reforms and interventions will prevent future governance failures, excessive risk-taking, and market discipline deficiencies in the financial services industry, remains to be seen. Although many of these risks appear to have been mitigated, supervisors and regulators are becoming concerned about an emerging unintended consequence of the regulatory reforms.

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3. Chapter Three – Emergence of a Compliance Culture

3.1 Introduction

The objective of this chapter is to demonstrate – through a review of existing literature – that, notwithstanding the noble intentions of regulators and supervisors, their extensive regulatory reforms were not effective in preventing the re-occurrence of corporate failures and poor governance.

Even though SOX's reforms benefited many larger financial institutions and their stakeholders, I will demonstrate how these reforms resulted in an inefficient regulatory framework with unintended consequences, and – ultimately – the inability to address poor governance and prevent corporate failures.

I will show how – six years later – the global financial crisis exposed SOX and other regulatory reforms' inefficiencies, and how financial institutions exploited significant shortcomings in regulation and supervision. The decade following the financial crisis was marked by increased global regulation of the banking sector. In this chapter, I will show that – despite the positive reforms of the Dodd-Frank Act and the Basel framework – there were also unintended consequences and trade-offs with substantial costs to efficiency and economic growth, as with SOX a few years before.

In summary, I will discuss how regulatory reform – at least in the financial services sector – did not achieve the desired and intended objectives of a stable, disciplined, and efficient financial system. I will explore the emergence of a compliance approach or culture as an unintended consequence of regulatory reform. I will conclude by discussing how neither this compliance approach nor culture effectively transformed the financial industry. The failings of a compliance culture as a reason for the shift towards an ethical culture will then set the context for a discussion in Chapter Four.

3.2 Failings of Regulatory Reform

3.2.1 The Sarbanes Oxley Act and the Basel Framework

According to an article published in The Economist (2005), SOX was one of the most controversial and influential securities regulations of its time. Although modest in its

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original objective to restore confidence in US capital markets, SOX's methods were far from subtle.

Aside from increased disclosure requirements, SOX introduced significant corporate governance reforms unprecedented in the history of securities legislation. This hard-line governance approach resulted in a substantial and disproportionate increase in compliance costs for organisations. Public companies spend millions of dollars each year to comply with checklist compliance requirements imposed by SOX, the SEC, and stock exchanges (Smith & Walter, 2006).

According to Protiviti's Annual Sarbanes-Oxley Compliance Survey (2016), nearly one-third of US companies spent $500 000 or less on compliance each year. Just under half of companies spent less than $1 million, but a significant number of large companies – primarily in the financial sector – spent around $2 million per year. Solomon and Bryan-Low (2004) argued that while out-of-pocket compliance costs were considered significant, the opportunity costs imposed by SOX on businesses would likely outweigh all other related compliance costs. In her research on the economic consequences of SOX, Zhang (2003) found that market prices fell by $1.4 trillion between the time the Act was proposed and when the final regulations were passed. In light of this, Zhang (2003) contends that SOX's high costs outweighed the benefits to investor confidence in US capital markets.

Burrows (2008) argues that a notable consequence of SOX was a significant increase in the number of public companies that delisted from stock exchanges, citing disproportionally high compliance costs as the reason for their decision to delist. Within two years of its implementation, 370 publicly listed companies were delisted from exchanges and converted to over-the-counter trading, effectively excluding them from SOX regulation. Despite his initial support for SOX, former Federal Reserve Chairman, Allan Greenspan, stated that SOX discouraged risk-taking and effectively deterred foreign companies from listing on the New York Stock Exchange (Bianco, 2006). The untenable situation created by the reform drove US companies to expand into markets beyond the scope of SOX.

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The most frequently criticised SOX requirement (the section 404 attestation) holds executives accountable for maintaining adequate internal control structures for financial reporting and requires companies' auditors to attest to the executives' assessment of internal controls. In cases of non-compliance, this resulted in draconian criminal penalties for executives. According to Solomon and Bryan-Low (2004), with increased litigation risk and harsher penalties, executives indicated that complying with regulations took their attention away from doing business. CEOs also made less risky decisions, which resulted in altered business strategies and – most likely – lower company market values (Ribstein, 2002).

SOX's provisions governing audit and accounting firms also produced a notable unintended consequence. SOX essentially provided a financial goldmine for auditors and accountants – the same profession that regulators believed contributed to the failures and whom SOX sought to regulate and supervise. The Economist (2005) quoted Deloitte who found that demand for accountants surged as large accounting firms have spent nearly 70,000 additional man-hours on average to assist companies in complying with the new provisions.

After the demise of Arthur Andersen, the four remaining audit firms, PriceWaterhouseCoopers (PwC), KPMG, Deloitte, and Ernst & Young audited 97% of all large organisations in the United States. The American Electronics Association (which represents 2,500 businesses and is an outspoken critic of SOX) added that the resulting lack of competition among auditing firms significantly increased compliance costs for companies (The Economist, 2005).

In many ways, though, the passage of SOX was not a watershed moment for financial institutions. Many private and public banks were already subject to a multitude of regulations and oversight. Furthermore, SOX was modelled after the Federal Deposit Insurance Corporation Improvement Act, which was enacted to reform banking institutions following the savings and loan crisis of the early 1990s (Falanga, 2006). Banking institutions were already subject to the strict supervision of federal agencies such as the Federal Reserve Bank, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and state banking departments. America's Community Bankers (ACB) testified before the Senate Committee on Banking,

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Housing, and Urban Affairs that additional SOX compliance would be unnecessarily costly, burdensome, and likely result in severe unintended consequences for banking institutions (Falanga, 2006).

One must question whether SOX was truly successful in reforming corporate accounting practices and restoring trust in the US financial markets. The answer is complicated in that, while there were indeed many positives, there were also several inefficiencies and unintended consequences. Maybe there was more to the failures at Enron and WorldCom than mere accounting irregularities. Primbs and Wang (2016) suggest that SOX only addresses the symptoms of corporate governance failures rather than the underlying causes. This would mean that the first post-SOX corporate failure would be very revealing.

It did not take very long after the introduction of SOX before the first major corporate failure made headlines. Lehman Brothers, a global US investment bank, went bankrupt within weeks in September 2008. Other US investment firms, such as AIG, Bear Stearns, Merrill Lynch, and the two government-sponsored enterprises, Freddie Mac and Fannie Mae, quickly followed with a liquidity crisis that necessitated intervention by the Federal Reserve Bank.

Blundell-Wignall *et al*. (2008) suggested that the financial crisis was primarily caused by global macroeconomic policies that affected liquidity in international markets. Rather than serving as an effective second line of defence, they contended that regulatory frameworks contributed significantly to the crisis. Kirkpatrick (2008) believed that SOX had an indirect impact on the crisis, at least in the US. According to Kirkpatrick (2008), the new definitions of independence in relation to conflicts of interests made it nearly impossible for financial institutions to find independent directors with the necessary expertise in their field. The pressure to find independent directors compelled boards to prioritise avoiding conflicting interests over director competence. In a US survey of eight major financial institutions, researchers found that two-thirds of independent directors had no banking experience. As a result, boards could not effectively monitor governance in the period leading up to the global financial crisis (Guerrera & Thal-Larsen, 2008). Boards' inability to effectively monitor governance had far-reaching consequences. As reviewing and guiding enterprise

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risk policy is a critical function of the board, the inclusion of inexperienced independent directors resulted in inadequate board oversight in financial institutions in the run-up to the crisis.

Kirkpatrick (2008) believes that risk management frameworks – which should have addressed incentive schemes that encouraged and rewarded high levels of risk-taking – were one of the primary causes of governance failures in firms. He believes that financial institutions' approach to SOX compliance also played a role. Most financial institutions missed the original purpose of regulatory reform by aiming to do the bare minimum through a tick-box approach.

According to Kirkpatrick (2008), SOX's disclosure and accounting requirements may have contributed to poor corporate governance outcomes. Banks, for example, began to develop new financial assets such as securitised and structured finance instruments in response to pressure to generate new revenue streams. Investment banks began to hold these assets off their balance sheets in order to avoid SOX's stringent disclosure and accounting standards. Of course, another advantage for banks structuring assets off-balance-sheet was the ability to avoid another set of regulations. Under Basel I, maintaining mortgages on the balance sheet would have necessitated increased capital reserves for banks, resulting in lower returns on shareholder investments. In a highly competitive industry, a bank holding these assets on its balance sheet would be significantly disadvantaged compared to a competitor who had moved such assets off-balance sheet.

The crisis, however, was not limited to the US. It spread quickly throughout Europe and other parts of the world. Soon after US financial institutions faced liquidity problems, European banks such as UBS, Credit Suisse, RBS, Barclays, Société Générale, and Fortis followed suit, requiring additional capital to finance significant realised asset losses. For the first time in 150 years – and the first casualty of the crisis in the UK – Northern Rock Bank was nationalised.

The role of supervisors and regulators in the global financial crisis should not be overlooked. According to Blundell-Wignall *et al*. (2008), weak regulatory frameworks contributed to the crisis because regulatory and governance frameworks failed to address mortgage securitisation and off-balance-sheet activity as early as 2004.

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Bear Stearns, Merrill Lynch, CitiBank, and AIG were all prominent in exploiting gaps in the transition to Basel II and SEC rule changes in 2004.

Blundell-Wignall *et al*. (2008) further argue that the theoretical underpinnings of the Basel framework were complex and based on the unrealistic assumption that there is only one universal global risk factor. Furthermore, regulators permitted banks to conduct complex internal risk modelling, allowing them to set their own capital standards. As a result, it was unsurprising that the outcomes produced concentration distortions and insufficient capital reserves. In an article published in The Economist (2013), the view was expressed that regulators' complacency in tolerating reckless borrowing and excessive risk-taking by financial institutions contributed significantly to the global financial crisis and the resulting economic destruction.

Excessive regulation, according to Smith and Walter (2006), causes as much harm as inadequate regulation. They believe SOX and the SEC may have gone too far with regulatory reform to be effective. When the 2008 global financial crisis unfolded in front of supervisors and regulators, that suggestion may have rung true.

3.2.2 The Dodd-Frank Wall Street Reform Act

There was a strong emphasis on regulatory reform following the global financial crisis, with numerous proposals from various constituencies for a reformed regulatory infrastructure. The US led the way with a comprehensive overhaul and transformation of its financial regulatory system. The Dodd-Frank was enacted to increase financial stability and prevent future economic devastation. Supervisors and regulators believed that Dodd-Frank would bring about a financial services sector that was much safer than before the global crisis.

Dodd-Frank has accomplished much since its inception, but – as with all sweeping reforms – there have been issues with implementation and, as with SOX, unintended consequences. The US government's plans to contain the financial crisis were unpopular from the start. Americans were vehemently opposed to the government bailing out prominent and ostensibly wealthy financial institutions. In subsequent polls, the public was also of the opinion that the bailouts had not made the US economy any more stable or secure (Dugan, Fisher & Muckenfuss, 2014).

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Authors Baily, Klein, and Schardin (2017) contend that a complete account of Dodd-Frank must assess how it has balanced financial stability and economic growth in a sustainable manner. They highlight two provisions where they believe Dodd-Frank, in fact, harmed both financial stability and economic development and was detrimental to one while providing little benefit to the other.

The first provision was requiring the Federal Reserve Bank to make emergency loans available to a broad range of financial institutions rather than just the one in need. The second requirement was that the Federal Deposit Insurance Corporation obtain a resolution from Congress before providing temporary liquidity guarantees for debt. According to Baily, Klein and Schardin (2017), these two provisions were expected to reduce financial stability during prolonged periods of distress while having no corresponding effect on improving economic growth in the long run.

Other Dodd-Frank provisions came at a high cost in terms of efficiency and economic growth. The Volcker Rule – which prohibits commercial banks from engaging in proprietary trading – and the Lincoln Amendment – which prohibits asset swap institutions from receiving federal assistance – both created costly trade-offs in the sector. According to Baily *et al*. (2017), the Volcker Rule was expensive, complex, and ambiguous – making it difficult for financial institutions to follow and challenging for supervisors and regulators to oversee. On the other hand, the Lincoln Amendment's goals could have been met by implementing the Volcker Rule in any case, saving on high costs and additional regulatory burdens.

Skeel (2010) was even more sceptical of Dodd-Frank. He contended that unless certain aspects of the Act were curtailed, it would entrench the worst of regulatory interventions as long-term regulatory policy. Skeel (2010) believes that the problem is not with the Act's objectives (which he believes are on target), but instead with how they were implemented. He emphasises two recurring and specific themes: the US government's collaboration with large financial institutions and ad hoc intervention by regulators rather than a predictable, rules-based response to crises. According to Skeel (2010), each has the potential to distort the US financial framework, making it more politically charged, less exciting, and further removed from fundamental rule-of-law principles.

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The concern with the US government's collaboration with large Wall Street banks and financial institutions was that Dodd-Frank designated certain financial institutions for preferential treatment. Banks that exceeded the $50 billion threshold and other financial institutions designated as systemically important by the Financial Stability Oversight Council, were essentially viewed as too big to fail. As a result of this provision, these financial institutions gained a competitive advantage by, for example, being able to borrow money more cheaply than their competitors. On the other hand, Skeel's (2010) concern revolves around the systemic risk that special treatment for Wall Street banks creates and, as a result, the political policy levers given to the US government.

The second point of concern raised by Skeel (2010) is that Dodd-Frank allows for ad-hoc interventions by regulators. One example of this unrestrained regulatory discretion is the resolution rules for distressed financial institutions. These rules enabled regulators to intervene if they believe a bank is in default or on the verge of default. This ad-hoc, almost subjective intervention could have severe consequences for the rest of the financial system's stability. According to Skeel (2010), this provision in Dodd-Frank undermines the fundamental expectation that rules be transparent, predictable, and not left to the whims of supervisors and regulators.

Skeel (2010) concludes by pointing out an ironic Dodd-Frank outcome. In some instances, the ability of regulators to intervene on an ad-hoc basis was precisely what many American taxpayers found offensive at the start of the crisis when the Federal Reserve Bank bailed out selected wealthy financial institutions. Concerns expressed by American taxpayers about Dodd-Frank's failure to improve the stability and security of the US economy appeared to be justified.

The objective of supervisors and regulators with Dodd-Frank was undoubtedly noble. The Act appeared to target the riskiest areas of the financial system. However, it was the implementation that resulted in significant unintended consequences. These unintended consequences significantly harmed Dodd-Frank’s effectiveness. One of the Act's objectives was to restore confidence in the financial system and to improve stability, but looking back over the last decade, little of that has been accomplished.

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3.2.3 Basel III

The Basel Committee on Banking Supervision introduced the Third Basel Accord (Basel III) in 2010 as another aggressive response to the deficiencies in financial regulation exposed by the global financial crisis. The Basel Committee extended membership to all G-20 countries to establish Basel III as an internationally agreed set of standards to strengthen the regulatory framework on capital adequacy, supervision, and market liquidity risk management. Basel III, in essence, sought to prevent another global banking crisis and corporate failures by requiring banks and other financial institutions to hold more stable assets and fewer risky ones.

Lall (2012), on the other hand, argued that many of the same factors that contributed to Basel II's failure reappeared to undermine its successor. Basel III simply expanded and broadened the existing Basel II regulatory framework without fundamentally challenging its core principles. Although Basel III aimed to address the major contributing factors that led to the global financial crisis, these objectives were premature because large international banks could exert control over the regulatory reform process (Lall, 2012). Given that large financial institutions were represented on the Basel Committee, they would be best informed about the committee's agenda and would have a first-mover advantage in negotiations about the proposed new Basel provisions. As a result, large financial institutions had significant success in weakening specific requirements, such as making key provisions non-binding (moving them from Pillar 1 to Pillar 2) and delaying implementation deadlines due to industry pressure.

From a different perspective, Chorafas (2012) argued that – notwithstanding the Basel Committee's good intentions – individual countries, predominantly from the West, continued to protect their own financial institutions which they rescued from bankruptcy using generous amounts of taxpayers' money. Slovic (2012) believed that Basel III was having a negative impact on financial system stability by increasing incentives for financial institutions to circumvent the regulatory framework and exploit regulatory loopholes.

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In the aftermath of the global financial crisis, it became apparent that most of the Basel Committee's proposed Basel III reforms would not be implemented, would be significantly diluted, or would be delayed for an indefinite period of time. Almost a decade later (in March 2020), the Bank of International Settlements (2020) announced that Basel III implementation had been extended once more, with standards for certain risk frameworks and the revised Pillar 3 disclosure framework being extended to 2023 and accompanying transitional arrangements being extended to 2028.

The Basel Committee has attempted to strengthen global capital standards in response to an international financial crisis twice in the last 25 years – and both times it has failed. This failure did not bode well for Basel III's stated aims of reforming and strengthening the regulatory framework to prevent another global banking crisis and corporate failures.

It can be argued that regulators and supervisors had noble intentions with the Basel III and Dodd-Frank reforms to transform the financial industry and to be more resilient to future devastation. However, it appears that despite the major reform, the inefficiencies and unintended consequences were simply too significant to achieve sustainable transformation. Let us explore in more detail whether regulatory reforms were effective in preventing future corporate scandals and failures.

3.2.4 Were post-crises regulatory reforms effective?

The first signs of corporate wrongdoing emerged not long after the global financial crisis. An international investigation into the London Interbank Offered Rate (LIBOR) in early 2012 revealed widespread collusion by several banks, most notably UBS, Barclays, Royal Bank of Scotland, and Deutsche Bank to manipulate LIBOR rates (McBride, 2016). Many other banks followed suit, admitting to similar wrongdoing. Even more corporate scandals followed, and by 2015, serious misconduct involving financial institutions in the US and Europe dominated global headlines.

It appeared as if financial institutions were incapable of learning from their mistakes, and regulators – in turn – were unsuccessful in their attempts at reform. The gold and silver price-fixing offences committed by Barclays Plc and other international banks

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(Slater & Jones, 2014), Wells Fargo's fake account violations in 2016 (Tayan, 2019), US Bancorp money-laundering control failures (Schroeder, 2018), the Australian banks' fee scandal (Schroeder 2019), and the money-laundering investigation into Danske Bank were prominent examples of corporate failures. Jensen (2018) corroborated this in his view that the incidence of corporate failures and fraud was historically contingent on and slanted towards the banking and finance sectors.

It is not without reason that both regulators and the financial services sector cannot seem to get it right when it comes to transforming the industry. Regulators appear to believe that the solution to a failing industry is more regulation. When regulators fail, the answer seems to give those same regulators even more control over the financial system.

The financial sector's inability to transform, however, appears to be a little more complex. Many financial institutions attempted to manage the ever-increasing regulatory risks by implementing compliance programs in the hope of regaining stakeholders' trust. However, these compliance programs did not have the desired results for the sector. It may be worthwhile to gain a better understanding of why the compliance-based approach was unsuccessful.

3.3 The Dark Side of a Compliance Approach

3.3.1 Introduction

The term 'compliance' has a straightforward meaning in everyday parlance. It simply entails adhering to instructions and rules to the letter. The Oxford Advanced Learner’s Dictionaries (2020) defines compliance as “the practice of obeying rules or requests made by people in authority”. In a more specific financial services context, Lin (2016) defines regulatory compliance as the aim that organisations strive for to comply with relevant policies, regulations, and laws. Interligi (2010) adds that compliance has traditionally been defined as conformity or obedience to the law and regulations as an organisational outcome.

The adoption of the compliance-based approach to governance has grown at an exponential rate in the last two decades. However, an essential criterion for compliance-based programmes' success is whether regulatory reforms accomplish

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their policy objectives. The recurrence of financial misconduct and corporate failures suggests that these compliance-based programs did not achieve their primary goals of preventing further corporate scandals and financial crises – particularly in the financial services sector. Despite significant increases in regulation and the sophistication of compliance-based programs, the results have been unsatisfactory.

Nelson (2020) believes that compliance should ideally have aspirational goals that deter outright violations of the law and encourage ethical behaviour in general. Nelson, however, adds that the more we learn about the compliance approach's inefficiencies and unintended consequences – what he refers to as the “dark side” of compliance – the more cautious everyone should be in using its instruments (Nelson 2020:5).

In seeking an explanation for the financial services industry's lack of transformation, it may be worthwhile to gain more insight into the dark side of compliance and identify some of its more harmful characteristics. While the high cost and complexity of regulation are universal across the financial services sector, many corporate failures exhibited one or more of the other characteristics that I will discuss in greater detail now. To fully understand the impact of the dark side of compliance on the industry, I will briefly discuss the cost and complexity of regulatory compliance in the sections that follow.

3.3.2 Significant Cost of Compliance

The financial services sector has repeatedly cited compliance costs as a significant burden to bear. Complying with regulations had become an increasingly complex, cross-functional effort. Compared to pre-financial crisis spending levels, operating costs spent on compliance have increased by over 60% for retail and corporate banks (Deloitte, 2017). According to estimates, tier one banks spent well over $1 billion per year on compliance-related costs, or approximately $270 billion per year for the industry as a whole in the decade that followed the 2008 financial crisis. This accounts for more than 10% of the operating costs of the majority of banks (Farley, 2017).

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Regulators bear the primary responsibility for the rapidly growing cost of compliance. Banner (1997) explains how, in the aftermath of financial crises and corporate scandals, regulators and policymakers frequently overreact by introducing omnibus legislation. Given the resulting uncertainty in the regulatory landscape and increased regulatory scrutiny, many large financial institutions invested significant resources in compliance efforts to meet the demands of these broad regulatory reforms (JPMorgan Chase & Co, 2015). While investing in compliance frameworks is a good thing, it also creates a complex compliance landscape for financial institutions to navigate.

As legislators attempt to regulate more and more aspects of financial services, financial institutions find it increasingly difficult and costly to implement controls to mitigate compliance risk. Calderón, Piero and Redn (2018) contend that attempts by legislators to control through a combination of regulation and control responses have proven ineffective. Even if it were possible, it would be prohibitively expensive.

3.3.3 Increasing Complexity of Compliance

Lin (2016) contends that increased compliance in the financial sector, in particular, can be attributed to the greater complexity of financial regulation and markets, as well as increased scrutiny by regulators in the post-Enron period. This increased complexity therefore aided in the development of intricate compliance-based programs in the financial sector.

Today, financial institutions conduct business on a global scale and are governed by several regulatory frameworks that span multiple jurisdictions and regulators. Organisations subsequently developed elaborate multi-faceted compliance programs to mitigate risks associated with their geographical footprint, often causing more harm than good. For example, under the guise of innovation, financial institutions use arbitrage opportunities in different jurisdictions to evade or circumvent regulations.

In a vicious cycle, regulators, in turn, responded with reforms that increased market complexity, requiring financial institutions to devote even more resources to compliance programs and market practices (Martin, 2015). The systemic failures

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during the global financial crisis and the international LIBOR scandals exposed the complexities of embedding an effective compliance culture (Burdon & Sorour, 2018).

3.3.4 Fear-driven compliance

Fear-driven compliance is described by Scholz and Pinney (1995) as the motivation that stems from the fear of being caught or punished for disobedience. Behaviour within fear-based compliance program functions under the assumption that adherence to the rules and regulations will suffice in preventing any potential legal liability. Behaviour is, therefore, primarily motivated by – at least from a regulatory perspective – the fear of punishment or loss of reputation (Verhezen, 2010). With fines of up to $5 million and a maximum of 20 years imprisonment under SOX and up to $725,000 per act with significant restitution and civil penalties under Dodd-Frank, regulators made it clear that non-compliance will be severely punished. To demonstrate regulators' authority, fines levied against the world's largest institutions since the financial crises have far exceeded $100 billion (Chaudhuri, 2014).

Another example of fear-driven compliance was when regulators used the size and severity of their penalties to incentivise institutions to implement compliance programs (Martin, 2015). Following the Sentencing Reform Act, the Federal Sentencing Guidelines used a scoring system to determine the penalties for offenses. The culpability score and the sanction were both raised by aggravating factors, while the score and sanction were both reduced by mitigating factors. For example, having an effective compliance program would be considered a mitigating factor because – from the regulators' perspective – it would assist the financial institution in reducing the risk of non-compliance, while from the financial institution's perspective, it would mean avoiding massive penalties and reputational damage.

Regulators' hard-line enforcement of regulations also compelled institutions to do even more to comply with regulatory requirements. The SEC and Department of Justice's expanded powers to investigate, prosecute, and even sue financial institutions for improper conduct put significant pressure on them to comply.

A fear-driven approach to compliance, according to Rossouw (2020), has two disadvantages. To begin with, it is impossible for organisations to always monitor

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everyone while they perform their duties. Secondly, fear-based compliance undermines employees' willingness to act ethically. As a result, rather than being intrinsically motivated to do the right thing, employees' behaviour is extrinsically motivated by fear of punishment. Steare (2015:4) supports this view, arguing that companies lacking an "ethic of care" engage in fear-driven compliance at the expense of doing the right thing. As a result, fear-based compliance programs harm ethical creativity and, in most cases, lead to moral silence in organisations (Verhezen 2010).

3.3.5 Window-dressing compliance

Window-dressing refers to practices that are used to enhance the appearance of an organisation's governance or financial records. Window dressing is particularly prevalent in organisations with a large number of stakeholders, as it enables management to portray an image of a well-run business. However, the entire concept of window dressing is problematic since it is misleading.

The collapse of Lehman Brothers in September 2008 was widely regarded as the catalyst for the global financial crisis. Investigations into the collapse revealed that prior to the bank's collapse, its executives resorted to extraordinary measures to conceal the actual financial position of the bank (Knowledge@Wharton, 2010). For example, to portray compliance with SOX, Lehman overstated its financial health to its stakeholders by temporarily moving distressed assets off its balance sheet.

The Wells Fargo scandal was another example of window-dressing governance and compliance. According to Tayan (2019), the bank had – in theory – several safeguards in place to prevent non-compliance. Employee handbooks described what a violation of sales integrity entailed. The bank had also implemented programs to teach employees how to identify and manage conflicts of interest. It even established a hotline to report violations to senior management. On the other hand, management was governed by a different set of rules to that of the rest of the organisation. Management also left control functions severely constrained and reduced them to only playing a window-dressing role.

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It is clear from these examples of corporate scandals, and arguably many others too, that window-dressing compliance lends itself to inefficiencies that contribute to corporate failures. Window-dressing compliance only creates a shiny façade of good governance and compliance without significant material substance behind it.

3.3.6 Tick-box compliance

The tick-box approach to compliance has been one of the more prominent characteristics of the dark side of compliance. Tick-box compliance (also known as letter-of-the-law compliance) occurs when organisations adhere to the letter rather than the spirit of the law. In practice, this means that the organisation adheres to a particular provision in a literal sense without observing the spirit of the law or the underlying principle (Reddy, 2018). This approach differs from the malicious compliance approach – which I will discuss later – in that the organisation's intention is not devious. Organisations often decide to err on the side of caution rather than taking on unnecessary regulatory risks.

While the tick-box approach appears to be what regulators require of financial institutions, it has been demonstrated to have significant unintended consequences. Moosa (2010) identified this approach to Basel II compliance as far back as the global financial crisis when financial institutions engaged in a box-ticking exercise concerning their solvency levels. He contended that the cause was financial institutions' preoccupation with following the letter of the law by focusing on internal prevention and self-reporting rather than with bona-fide risk management that ensured they could withstand crisis events.

In an effort to minimise box-ticking, regulators reduced the number of prescriptive provisions and introduced outcome or principle-based regulation and governance codes instead. Although the Cadbury Report (1992) recommended its comply-or-explain approach as far back as 1992, it is only now with outcomes-based legislation such as Treating Clients Fairly and principles-driven corporate governance codes that a level of flexibility is provided for financial institutions to comply with the original aim and spirit of the law. In an example of this regulatory approach, David Blunt (the Financial Conduct Authority's Head of Conduct Specialists) urged financial

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institutions to stop adopting a tick-box mentality in the wake of the LIBOR scandal, ostensibly addressing the emerging dark side of a compliance culture (Reuters, 2019).

3.3.7 Malicious compliance

The malicious approach to compliance is closely associated with tick-box compliance in that malicious compliance occurs when organisations or employees interpret the rules too literally. I explained earlier that the distinction is primarily based on the devious intent of malicious compliance. In these instances, organisations or employees remain within the legal framework since they are following the rules but have no intention of complying with the spirit of the law.

Kirkpatrick (2009) uses an example to demonstrate how banks followed a malicious compliance approach during the global financial crisis. The requirement was that credit lines extended to clients had to be covered by banks' capital reserves if the lending term was for a year or longer. Banks simply opened credit lines for 364 days – rather than 365 days or longer – to circumvent this requirement. Banks had no intention of complying with the spirit of the law which required banks to maintain sufficient reserves for long-term credit. They interpreted the provision literally with the malicious intent of circumventing it.

Although malicious compliance is driven primarily by human behaviour, it is often aided by a defective regulatory framework. When ineffective regulatory frameworks span across multiple jurisdictions, devious financial institutions capitalise on loopholes in these regulatory frameworks (also called regulatory arbitrage) to circumvent unfavourable regulations. McBride (2016) describes how traders and brokers colluded at a global level during the LIBOR lending rate scandal to exploit regulatory loopholes while remaining within the letter of the law. There is a wealth of literature demonstrating how investment banks circumvented laws and used loopholes during the pre-and post-global financial crisis periods while still adhering to the letter of the law.

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3.3.8 Closing thoughts

I demonstrated in this chapter how the measures put in place by regulators to prevent future corporate failures were ineffective and resulted in significant unintended consequences. I discussed how extensive regulatory reforms sought to transform the financial services sector, ultimately failed. Anand, Ashforth and Joshi (2004) offers the view that regulation and compliance-based programs, in their current form, cannot ensure compliance and that a different approach is required.

I also discussed in detail how the financial services sector had developed a compliance approach and culture over the last two decades. This compliance approach, intended to mitigate the severe regulatory risks, has been ineffective. The primary cause of this failure was the emergence of a 'dark side' to the compliance approach. I examined this ‘dark side's’ unique characteristics and demonstrated how it contributed to the financial sector's failures.

In response to the financial sectors’ failures, regulators have been calling for a new approach aimed at changing the financial sector's attitude toward governance and corporate culture. However, changing organisational culture in the financial services sector may require a shift in mindset and approach to achieve long-term and sustainable success. In the next chapter, I will explore this new approach regulators are calling for and explain the motivations behind this emerging shift in emphasis away from a compliance culture.

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4. Chapter Four – Transition from a Compliance Culture to an Ethical Culture

4.1 Introduction

In this chapter, I will demonstrate – through a review of existing literature – that regulators, industry bodies, and reformists are calling for a change in approach due to the ineffectiveness of regulatory reform to transform the financial sector over the last two decades.

I will discuss recent global regulatory developments in the financial services sector, including recommendations by the Salz Review, the G30 Steering Committee and Working Group, the UK Financial Reporting Council, and Codes of Good Corporate Governance for financial institutions. The central theme in these proposals is the pursuit of transformational change with a renewed emphasis on organisational culture.

I will conclude the chapter by providing an explanation for the emerging shift from a compliance-based culture to an ethical culture and the motivations behind it.

4.2 Emerging Emphasis on Culture

Financial sector supervisors and regulators hoped that regulatory reforms would address the mindset of short-term oriented performance and self-enrichment – cited as one of the leading causes of the financial crisis. Furthermore, corporate scandals have demonstrated how even the best supervision and regulatory frameworks have failed over the last two decades. Compliance programmes mandated by regulators have become increasingly burdensome, resulting in inefficiencies and unintended consequences. Ugeux (2016) believes the answer may lie in an aspect of financial institutions' behaviour that few have considered: culture.

Surprisingly, the initiative for this shift has come from regulators and not from the financial services industry. Ugeux (2016) suggests that the industry's reactive approach, by itself, should be considered a governance failure. According to Ugeux, despite regulators leading the charge for cultural awareness and change, they may not be able to push cultural transformation beyond a greater emphasis on regulatory compliance. Ugeux believed the change would have to come from inside the financial

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services industry, which will be a leadership challenge given the inherent nature of such a change. This point will be elaborated on to a greater degree at a later stage in this chapter.

The focus on culture in the UK started when Clive Adamson (2013) (then Director of Supervision at the Financial Conduct Authority (FCA)) stated in a speech at a CFA Society Conference that "the cultural approach of doing the right thing has been lost for financial services". Adamson added that he believed the critical driver of behaviour is the culture of an organisation. His view also mirrored an FCA statement in a thematic review of culture in banking. The FCA stated that "culture drives individual behaviours, which in turn affect day-to-day practices in firms and their interaction with customers. Culture is, therefore, both a key driver and potential mitigant of conduct risk. Experience demonstrated that poor culture could lead to poor outcomes for consumers and markets" (Financial Conduct Authority, 2015:1).

In support of this view, Bill Dudley (2015) – then President of the US Federal Reserve Bank – stated in a workshop on reforming culture and behaviour that a bank's culture, owing to the unique role that banks play in the economy, must promote decisions and behaviours that take into account the firm's numerous stakeholders.

Dudley added that even the most comprehensive compliance programme would encounter circumstances not provided for in regulations. According to Dudley, it is during those times that culture determines an organisation's decisions on the way forward.

In response to Barclays' role in the LIBOR scandal that broke in 2012, the bank's chairman, Sir David Walker, commissioned Anthony Salz to carry out an independent assessment of its values, principles, and standards of operation after the bank was fined a total of £290 million by US and UK regulators. The Salz Review (2013) found that in the years leading up to the 2008 financial crisis, Barclays pursued the bold growth strategy of becoming a global top-five bank. However, Salz (2013) found that this rapid growth gave rise to questionable cultural standards and business practices. Unsurprisingly, Barclays was not alone in this respect as other large banks also suffered from similar challenges. In October 2012, Stephen Hester, Chief Executive of RBS, stated that banks must undergo a fundamental transformation in their culture

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and refocus their behaviour on serving the requirements of consumers to rebuild trust in the industry. Salz (2013) raises the view that banks may have taken too much comfort from certain business practices being the norm in the industry.

Salz (2013) believes that despite a surge in new regulation and increasingly demanding regulators since the financial crisis, regulation alone would not have addressed the bank's bad business practices and cultural weaknesses. Barclays was too often perceived as a letter-of-the-law, as opposed to a spirit-of-the-law, organisation. In that respect, Salz (2013) concludes that transforming the bank's culture would require a new sense of purpose.

The G30 Working Group (G30) echoed regulators' views by finding in its Banking Conduct and Culture Report (2015) that a significant improvement in the culture of banks is a matter of economic necessity and is imperative for regaining society's trust. The G30 Report (2015:11) highlights major drivers of historical financial crises as “poor cultural foundations” and other “significant cultural failures”. Unhealthy cultural norms or subcultures have caused significant reputational damage to these organisations and harmed public trust. To overcome years of ingrained behaviours and attitudes and to guarantee that the changes are lasting rather than fleeting or merely short-term window dressing, the desired cultural shift will require leadership, resolve, and consistency.

The G30 Report (2015) suggested that for the industry to transform in an economically viable way, it needs to achieve greater success in internalising the ethical dimension of organisational culture. The ability of financial institutions to manage behaviour in grey areas, where adherence to conduct standards is a question of good judgment rather than ticking compliance boxes, appears to remain a significant problem.

Soon after the G30 Report was issued, the UK Financial Reporting Council (2016) published a report on corporate culture and the role of boards. The report examined the growing role of corporate culture in achieving sustainable success. According to the council's Chairman, Sir Winfried Bischoff, regulation, rules, and sanctions have their place, but they will not, on their own, result in long-term constructive behaviour. He continued by emphasising the need of organisations maintaining a consistent

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focus on culture, as a strong culture both generates and preserves value. Moreover, there is a reasonable likelihood of sustainable success when culture is connected to the organisation's purpose and strategy.

However, the shift in focus to corporate culture was not limited to the UK and the US. In November 2019, the Australian Prudential Regulation Authority (APRA) set out guidance in an information paper to financial institutions on how to improve their resilience by addressing standards of governance, culture, and accountability. The new approach has drawn on APRA's thematic evaluations of risk culture and remuneration, as well as the Prudential Inquiry into the Commonwealth Bank of Australia, and responded to the Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry's findings (Australian Prudential Regulation Authority, 2019). In the document, APRA stated its aim to build a supervisory program that emphasises organisations' risk culture. Risk culture, according to APRA, is not distinct from organisational culture but rather represents the effect of corporate culture on risk management.

In another part of the world, the King Committee's King IV Report on Corporate Governance 2016 figured prominently in South African companies' shift toward embedding an ethical culture. King IV, published in November 2016, built on its predecessors' positioning that sound corporate governance is an essential component of good corporate citizenship. According to Ramalho (2020), King IV interprets corporate governance as a progressive approach that enables organisations to achieve governance outcomes such as ethical organisational culture, sustainable performance, and legitimacy. In King IV, the focus remains on personal characteristics and values. Still, it moved beyond the cardinal values such as responsibility, accountability, fairness, and transparency to now also include integrity and competence. King IV shifted the focus to ethical culture as an outcome of good governance, instead of merely ensuring ethics is managed effectively in the organisation. For example, unlike principle 1.3 in King III that required the board to ensure that the company's ethics is managed effectively, principle 2 in King IV requires the Board to move beyond ethics management and “govern the organisation's ethics in a way that promotes the establishment of an ethical culture” (Ramalho, 2020:175).

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Supervisors, regulators and industry bodies appeared to be united in their calls for a shift towards an ethical culture in the financial services industry. Decades of regulatory intervention and reform did not result in adequate and sustainable reform of the financial services industry. In fact, in many respects, the regulatory reforms harmed the sector with its unintended consequences, which in turn created continuous new challenges for supervisors and regulators. More importantly, though, corporate failures and scandals kept on happening despite regulatory interventions. The question, then, becomes whether the shift towards ethical culture constitutes a solution, and whether it is – in fact – possible.

Achieving a successful transformation may not be easy. Donaldson (1989) argues that transformation is not in people's nature but rather in their attitudes. People's attitude shapes habits and behaviour, which ultimately influences an organisation's culture. To fundamentally change organisational culture is difficult. It will take a new approach and some time. Some organisations, however, have started to take on this new approach and are seeing the benefits of the shift. I will now explain why organisations are shifting from a compliance approach and culture to an ethical culture.

4.3 Reasons for the emerging shift to an ethical culture

In recent years, the emphasis on ethical culture in organisations has seen a significant increase. The G30 Report (2015:61) recognised the ineffectiveness of a compliance approach and called for a focus on culture and "to see achieving the desired conduct and values as essential to the sustainability and long-term viability of the bank, as opposed to a more defensive or compliance-based approach". Rossouw (2020) supports this view. He argues that there is a recognition that regulations and compliance, as vital as they are, are insufficient to ensure sustainable, ethical behaviour in organisations. Rossouw suggests that putting too much emphasis on regulation and compliance could become counterproductive and undermine ethical behaviour in the workplace.

Arjoon (2005) argues that regulatory frameworks alone are insufficient to deal with unethical practices, and mechanisms that promote ethical behaviour are therefore necessary. According to Rossouw (2020), two elements are most important in

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explaining the change to a focus on ethical culture. The first is about the inherent limitations of laws and regulations. Laws and regulations seek to define what behaviour is acceptable and what is not. Even the best-intentioned and best-articulated laws and regulations are ultimately just words on paper, unable to guarantee that people would adhere to such prohibitions and prescriptions.

The second element Rossouw (2020) identified that contributes to the emerging shift towards an ethical culture is the constraints of compliance itself. As discussed in Chapter Three, these constraints or characteristics of the dark side of compliance manifests in different shapes in an organisation. Fear-based, window-dressing, letter-of-the-law and a tick-box approach to compliance were discussed in depth as examples of the constraints of a compliance culture. Both the constraints of regulation and compliance have significantly contributed to organisations making the shift towards an ethical culture. With these constraints or the dark side of compliance as context, I will now discuss what I regard as the five main reasons for this emerging shift towards an ethical culture.

4.3.1 Supervisors and regulators are more effective

Regulators have a vested interest in seeing strong, healthy, and ethical organisational cultures since they will never have the time and resources to supervise every part of financial institutions' complex operations. Regulators and supervisors cannot develop culture, but they can play a crucial monitoring role (Salz, 2013) and complementary function in improving organisational culture (G30 Working Group Report, 2015).

Lin (2016) previously explained how the compliance culture, and the sophisticated compliance-based programs that followed, rose to prominence due to the growing complexity of financial regulation. He further contends that regulators will need fewer and less complex regulatory frameworks by relying on strong and healthy organisational cultures. Having less complex regulatory frameworks will aid regulators globally. It will, for example, reduce the risk of arbitrage opportunities for financial institutions in different jurisdictions. Mitigating non-compliance risks will enable regulators to shift from a reactive to a proactive supervisory strategy, allowing

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them more time and resources to entrench effective and healthy organisational cultures in the industry they regulate.

As an example of how regulators can benefit from strong institutional values and culture in regulated entities, Jackman (2001) proposes a competency model to develop suitable organisational values and an ethical culture. The model enables the Financial Services Authority (FSA) to consider the institution's culture and determine whether it meets the overall goals of the Financial Services and Markets Act 2000. Should the institution meet these broader goals, it will have the benefit of a softer regulatory touch. Regulators will be less likely to be prescriptive if improved cultural results are observed in the market.

Financial institutions will also benefit financially when regulators rely on less complex but more effective regulatory frameworks. Supervisors will have less need to control through a mix of regulation and control responses since there will be less need to regulate all aspects of financial services. More regulatory certainty and reduced regulatory scrutiny will enable companies to reinvest savings from compliance efforts in more worthy areas of the business.

4.3.2 Intrinsic motivation drives ethical behaviour

In Chapter Three, I discussed the dark side of the compliance approach, which Verhezen (2010) described as behaviour in fear-based compliance programs motivated by the fear of legal liability, sanction, or reputational damage. To put it differently, regulated entities generally comply with regulation out of fear of punishment or loss of some sort and not necessarily because they want to do the right thing.

Although Howse (2010:129) suggests that lawfulness is an "endogenous preference" of an individual, he cites research by Goldsmith and Posner (2006) that found that the majority of instances of compliance with legislation occurred when the complying entity acted in its own self-interest, for example, to avoid reputational damage. This self-interested approach by institutions creates an unintended constraint for the financial sector's transformation beyond mere compliance. Howse (2010) cites Immanuel Kant's definition of law (Recht) to argue for the financial sector's precarious

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position. According to Kant (1797), the law requires only external obedience; unlike moral virtue, regardless of heteronomous considerations, it is not a habit of mind that compels compliance based on duty alone. Therefore, the solution may be a shift toward an ethical culture in which intrinsic motivation, rather than extrinsic motivation, drives organisational behaviour based on a duty to society.

Considering Steare's research into the motivations of human behaviour, one might argue that a shift from a compliance culture to an ethical culture will benefit the financial services sector, but also its stakeholders and, ultimately, the regulators. Extrinsic motivations behind organisations' fear-based compliance behaviour will make way for intrinsic motivation that will focus on outcomes and ethical considerations. Salz (2013) confirmed this view by suggesting that when motivated intrinsically, people generally perform better and more consistently than when motivated extrinsically.

The emphasis for organisations with an ethical culture would no longer be on fear-driven compliance, but instead on care and considerations of outcomes that would benefit customers, stakeholders, entrepreneurship, and their performance. Sir Peter Gershon, Chairman of the UK National Grid, stated that culture is an essential component of conducting good business and should be intrinsic in everything a company does (Financial Reporting Council, 2016).

4.3.3 Ethical organisations enjoy stakeholder trust

The Tonge *et al*. (2003:4) research paper (aptly titled "The Enron story: you can fool some of the people some of the time") described the Enron corporate scandal as the proverbial emperor's new clothes tale. This metaphor is not unique to Enron, however. In many subsequent corporate scandals – like Lehman Brothers and Wells-Fargo – companies employed the strategy of window-dressing to improve the appearance of the company's financial and governance performance before presenting it to stakeholders as evidence that the company is a good corporate citizen and can be trusted.

In Chapter Three, I discussed window-dressing as a dark side of a compliance-based approach and how financial institutions display a façade of compliance and

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governance structures to portray them in a better light. Rossouw and Van Vuuren (2017:248) explained how these companies manage "ethics" in a "reactive mode", with all the codes of conduct, compliance frameworks, and ethics artefacts in place, but nothing real or of ethical substance to support that claim. It mimics good corporate governance, but it is merely a semblance of a commitment to ethical values.

Schein's (2010) model of an ethical organisational culture is helpful as a point of reference for establishing whether the shift from a compliance culture to an ethical culture would benefit the financial services industry. Schein's approach suggests an observable dimension as well as a less observable dimension to organisational ethical culture. Window-dressing compliance merely mimics the observable dimension of an ethical culture such as codes, policies, and other ethics artefacts. The organisation's culture lacks the less observable dimension. There are no stories, taboos, business practices, and customs to support and inform the observable dimension.

Financial institutions that have cultivated an ethical culture will develop this less observable dimension over time, which will play a significant role in creating a deep ethical organisational culture. Because, as Rossouw and Van Vuuren (2017) argue, a deep ethical culture is driven by ethical leadership. One would expect leaders to model these values and have an ongoing symbiotic connection with the organisation's culture. Organisations that transition to a strong and united ethical culture, led by ethical leadership, will ultimately reap the benefits of stakeholder trust.

4.3.4 Ethical organisations observe spirit-of-the-law ethics

In Chapter Two, I described how SOX primarily focused on rule-based prevention and sanctioning corporate misconduct. SOX, however, also established incentives for ethical behaviour. I discussed in Chapter Three an example of how the Federal Sentencing Guidelines awarded extra points in its scoring system to organisations that had formal codes of ethics. The Guidelines prompted organisations to establish not only effective compliance programmes but also ethics programs (Gabel, Mansfield & Houghton, 2009). In practice, though, the emphasis fell on letter-of-the-law legal compliance focusing on prevention and self-monitoring rather than a spirit-of-the-law ethical approach.

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The G30 Working Group Report (2015) outlined how regulators, departing from their previous rule-and-control approach and in an attempt to encourage spirit-of-the-law conduct, promulgated a combination of rule-based and principle-based regulations. For conduct risk areas that are narrowly defined and contain explicit compliance requirements such as anti-money laundering and Know Your Client, stricter rules have been introduced. For principles-based requirements that are not easily translated into compliance requirements such as Treating Clients Fairly, product suitability, and customer affordability, regulators have provided lesser degrees of enforcement action.

Using traditional compliance-driven approaches to meet both types of conduct requirements would be ineffective. The conventional compliance-driven approach has demonstrated the capacity to produce inconsistent and unintended consequences. Furthermore, the approach has resulted in inefficient resource utilisation with no assurance of sustainable success (G30 Working Group Report, 2015). Establishing value systems beyond compliance criteria is essential as it creates a safeguard against behaviour sliding below an acceptable level (Jackman, 2001). The only realistic solution for organisations is to establish strong cultural foundations that benefit from a spirit-of-the-law approach.

4.3.5 Ethical organisations are better performers

Due to the shift toward an ethical culture, organisations are increasingly becoming aware of the benefits of an ethical culture. Those who have made the transition have discovered that ethical business practices and a culture of ethics improve their competitiveness, strengthening the argument that an ethical culture is critical for sustainable success.

A culture of ethics improving competitiveness is not a novel proposition, however. More than 25 years ago, Denison and Mishra (1995) discovered empirical evidence of the significance of an ethical culture in an organisation's long-term success. Sorenson (2002) furthered that argument, suggesting that strong cultures provide a competitive advantage by increasing motivation and putting a strong-cultured company in a better position to respond to investment opportunities. This could further bolster the organisation's competitive advantage. Arjoon (2005), more

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recently, added his voice to the argument that strong corporate governance founded on fundamental principles of honesty and trust helps an organisation's reputation and market position. As a result, customer loyalty and employee commitment would both improve.

In her recent research, Byrne (2019:1) empirically argued that companies with integrity and a strong ethics culture benefit from an 'ethics premium.' Byrne discovered that companies recognised by the Ethisphere Institute as the 'World's Most Ethical Companies' outperformed the US Large Cap Index significantly. As measured by their stock prices, the Ethisphere honourees outperformed the large-cap sector by 14.4% over five years and 10.5% over three years.

Alex Brigham, executive director of the Ethisphere Institute (2021) – which annually evaluates participating companies based on their ethics and compliance programs, a culture of ethics, corporate citizenship and responsibility, governance, leadership, and reputation – revealed that organisations are becoming increasingly aware that a strong ethical culture is critical to achieving financial performance. In a different set of performance metrics, organisations that foster an ethical culture are steadily moving to assist society by addressing diversity, inclusion, and human rights issues. These organisations measure, for example, whether employees feel comfortable speaking up, putting their trust in leadership, and taking personal responsibility for maintaining an ethical workplace. Consumers, employees, shareholders, and other stakeholders place a premium on ethical businesses. Being recognised as an organisation that adheres to the highest standards of ethics has turned out to be a competitive advantage that resonates with key audiences (Byrne, 2019).

4.4 Closing Thoughts

Given the significant damage to its reputation and erosion of public trust over the last two decades, the financial sector does not appear capable of self-correction and transformation. Supervisors, regulators, and industry bodies worldwide urge the financial services sector to adopt a new approach and focus on culture.

Historic attempts by supervisors and regulators to change the sector's behaviour through regulatory reforms were ineffective and frequently resulted in more harm

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than good. In an effort to exert greater control over all aspects of financial services, regulators have required financial institutions to implement stringent control systems, resulting in financial institutions implementing increasingly complex compliance programs. Compliance programmes, or more precisely, their dark side, were a significant contributor to the financial sector's inability to transform. Therefore, supervisors and regulators believe that the only way for the financial sector to truly transform itself is to shift to an ethical organisational culture.

The rationale for the shift is compelling. Regulators are increasingly cognisant of the fact that ethical culture cannot be regulated. Regulators recognised that, while they could encourage and nudge the industry in the right direction, the shift to an ethical culture would have to come from within the sector. In many instances, the financial sector has also recognised the need for a fundamentally different approach and is gradually making the shift toward an ethical organisational culture.

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5. Chapter Five – Conclusion

The objective of this study is to explain the emerging shift from a compliance culture to an ethical culture. This research topic is relevant because the financial services industry, particularly the banking industry, is undergoing a profound transformation, driven primarily by new competition from FinTechs, disruptive technologies, changing business models, and mounting regulatory pressures. Non-banking start-ups are reshaping the competitive landscape in financial services, compelling established financial institutions to rethink not only their business models but also their approach to developing these new business models. This new approach is evident in the growing number of financial institutions in the sector that have begun to shift away from a compliance-driven organisational culture toward an ethical one.

To accomplish the study's objective, I divided my research into three specific goals. First, to review the existing literature to demonstrate that in response to corporate failures, regulators implemented wide-ranging regulatory reforms with stringent regulatory compliance regimes in order to prevent future failures. Secondly, to establish that the regulatory reforms in place to prevent such occurrences were ineffective and resulted in significant unintended consequences. Thirdly, to explain the emerging shift from a compliance culture to an ethical organisational culture and the motivations for such a shift. I will now discuss the findings of the literature review in greater detail.

5.1 Summary of findings

5.1.1 Regulators introduced regulatory reforms in response to corporate failures

This study began with a literature review on how legislators and regulators implemented significant regulatory reforms in response to corporate failures. I examined the reasons why the Enron and WorldCom corporate failures were the catalyst that prompted regulators to refocus on governance for all corporates. I also explored the global financial crisis's ripple effect on global markets and how central banks and regulators introduced regulatory reforms to improve prudential and market conduct.

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This study found that despite the introduction of extensive regulatory reform in the Sarbanes-Oxley Act, it did not prevent or mitigate the 2008 global financial crisis. Financial institutions' sole focus on profits, distorted incentives for bankers, and regulators' laissez-faire attitude were all shown to have contributed to the financial crisis.

Supervisors and regulators responded with significant regulatory reforms, including the Dodd-Frank Wall Street Reform Act in the United States and other reforms such as Basel III in Eurozone countries. Furthermore, it was discovered that, while South African regulators did not directly respond to corporate scandals, they anticipated international regulatory developments and implemented the Twin-Peaks regulatory framework to govern companies' prudential and market conduct. LIBOR scandals at Barclays and other international banks have demonstrated that history, ironically, repeats itself. Regardless of supervisors and regulators' good intentions, their extensive regulatory reforms were ineffective in preventing future corporate failures and poor governance.

5.1.2 Regulatory reforms were ineffective to prevent the re-occurrence of corporate failures

This study found that despite having improved prudential and market conduct on many levels, these reforms also caused inefficiencies and unintended consequences, resulting in an inability to adequately address poor governance and prevent corporate failures. One of these unintended consequences of regulatory reforms was a compliance approach or culture that developed in organisations to mitigate the risk of non-compliance in a complex regulatory landscape. Although a compliance approach or culture has numerous benefits, it was found that the emerging dark side of the compliance approach or culture was a significant cause for concern.

This study examined this dark side of compliance and found that the cost and complexity of compliance were significant factors for financial institutions, particularly smaller firms lacking the resources necessary to implement effective compliance programs. Fear-driven, window-dressing, letter-of-the-law, tick-box, and malicious compliance were all found to be manifestations of this dark side of compliance. Most

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financial institutions employed one or more of these approaches to compliance, which were found to reflect the organisations' leadership styles and cultures.

5.1.3 There are multiple reasons for the emerging shift towards an ethical organisational culture

Regulators, industry bodies and reformists have been calling for a change in approach by the financial services sector. This study demonstrated how highly influential reports emanating from the Salz Review, the G30 Steering Committee and Working Group, and the Financial Reporting Council all emphasised the importance of refocusing on organisational culture. The characteristics of organisational culture were examined in relation to the Lehman Brothers and Barclays corporate scandals, and it was found that these companies lacked the critical element, the ethical dimension, of organisational culture.

The study found that regulatory frameworks alone were insufficient to address unethical practices, and thus approaches that promote ethical behaviour are necessary. The constraints imposed by laws and regulations were found as one of the motivations behind the shift. Another motivation was the constraints of compliance itself, particularly the dark side of the compliance approach.

I discussed five specific reasons for the emerging shift, each of which effectively mitigates the compliance approach's unintended consequences and contributes to the shift towards an ethical culture. The study found that regulators are more effective when organisations prioritise ethical behaviour. When employees are intrinsically motivated to do the right thing, it drives the organisation's ethical behaviour as well. Ethical organisations have been found to be honest and trustworthy and, as a result, to benefit from stakeholder trust. Organisations were found to perform better when they focused on the spirit of the law and establish value systems beyond compliance criteria. Organisations that have successfully made the transition have discovered that ethical business practices and an ethical culture increase their competitiveness, resulting in sustained success.

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5.2 Future Research

Due to this study's limited scope, additional facets of the emerging shift to an ethical organisational culture could be explored in future research. This study was devoted only to developments in the financial services sector. However, it may be worthwhile to investigate whether a similar reaction occurred in other sectors or if more effective regulatory mechanisms developed in other industries where corporate failures occurred.

Although this study focused on the current transition from a compliance culture to an ethical one, future research could explore whether compliance and ethics can be harmonised in a relationship that reinforces each other and yield positive synergies. Compliance and ethics do not always have to be mutually exclusive. Given the academic nature of this study, consideration must be given to the practical implementation of the emerging shift towards an ethical culture in organisations, at least in the financial services sector.

5.3 Final Thoughts

The financial services sector has a far more significant role in society than merely providing for the flow of capital and liquidity. It now has an opportunity to lead by example and directly impact good corporate citizenship in the industries they serve. Banks, in particular, play a critical role in promoting sustainable development and laying the foundations for economic growth.

While necessary steps have been made in the right direction, financial institutions must accelerate the transformation of their organisational cultures and business practices. Now, more than ever, the industry must reinvent and transform itself into a sector that is morally relevant, transparent, and accountable to all its stakeholders in a sustainable way.

"You cannot mandate an ethical culture, and you cannot just announce that you have one. You build it day after day, in the countless good decisions you make and – importantly – in the bad ones you do not make. You build it when you speak up about the things that do not seem right, and when you do not turn away from the things you see that you know are wrong." – Steve Milligan, CEO of Western Digital.

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