

The Atlantic

Can Bankers Behave?

Wall Street still has basically the same culture that led to the 2008 crash. But one big firm is trying to change—as government regulators begin to question whether financial institutions can be reformed at all.

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How deep do Wall Street's problems really go? Can they be rooted out by better-tailored financial incentives or farther-reaching regulations, the tools of choice of many pundits and government officials? Or could Wall Street's deepest flaws be *cultural*, promulgated over generations by leaders who have chosen to reward those who cut corners, stab colleagues in the back, and engage in otherwise unethical behavior?

This idea—that Wall Street takes in ambitious, hardworking young people and corrupts them—is the premise of a recent study, “Business Culture and Dishonesty in the Banking Industry,” by three economists at the University of Zurich. The researchers recruited 128 employees from a large, unnamed international bank and another 80 employees from other financial institutions and asked them to participate in a simple experiment. The typical subject had worked in banking for about 11 years—long enough to have fully absorbed the industry's cultural norms.

The task at hand was to flip a coin 10 times and report the outcomes of the tosses online. Subjects knew in advance whether heads or tails would be deemed the winner. If they reported that a coin toss yielded the right result, they would be given \$20. Otherwise, they'd get nothing. At most they could make \$200, or \$20 each for 10 correct coin tosses. No one was watching as the bankers flipped a coin or reported their results, allowing the researchers to try to isolate behavior that looked like dishonesty.

The results of the study were published in November, in *Nature*. Of course, the expected outcome is that half of each person's tosses were heads and half were tails. And that pretty much was the result the researchers found when the bankers were not reminded, through a series of social cues, that they were bankers. They reported a winning toss 51.6 percent of the time, an outcome that is statistically indistinguishable from the 50 percent expectation.

The result changed dramatically, alas, when the bankers were encouraged to remember their profession—a psychological phenomenon referred to as “identity priming.” When so prompted, they reported a winning result 58.2 percent of the time. It was very likely, the researchers found, that more than a quarter of the bankers had cheated. Worse, they discovered, this increased predilection to cheat was unique to banking. When nonbanker coin flippers were reminded of how they spent their time as professionals or as students, they showed no change in their tendency to cheat. “Our results thus suggest that the prevailing business culture in the banking industry weakens and undermines the honesty norm,” the researchers concluded. Or, more simply, as Alain Cohn, a lead author of the study, told me recently, “the apples are good, but the barrel is bad.”

That statement echoes James O'Toole and Warren Bennis, who observed in a 2009 *Harvard Business Review* article about corporate culture, “Ethical problems in organizations originate not with ‘a few bad apples’ but with the ‘barrel makers.’” The problem, Cohn believes, is a Wall Street culture that rewards bad behavior. “There are norms at their workplace that induce them to cheat,” he told me. “This is not present in other industries, at least in those we looked at.”

It's hardly scientific, but my own nearly six years of experience at Lazard, a small, elite investment bank founded in 1848, as a junior banker in the 1990s, squares with the academic findings. The other young bankers seemed incredibly smart, ambitious, hardworking, and ethical. The basic compact seemed to be: we will work absurdly hard and you will reward us with high pay and a fair promotion system. That worked for a while, but soon enough, those on the fast track—those getting higher pay and earlier promotions—seemed to have become less collegial and more Machiavellian. Some ignored phone calls from colleagues seeking help with analytical problems; others were ruthless in courting assignments working with “important” partners, elbowing out their peers. Nobody in charge seemed to mind. Rather, the powers that be seemed to encourage the Darwinian behavior. A common attitude at Lazard then was “It is not enough to succeed. Others must fail.”

Cohn thinks it's possible, even likely, that the causes of the 2008 financial crisis can be traced in part to this permissive culture. “All the problems that we are seeing in recent times, at least to some degree, might be supported by a norm, or by an environment, that tolerates these kinds of behaviors,” he told me. “They think it's okay to manipulate interest rates, to assist people in evading taxes, to sell mortgages that shouldn't be sold.” Organizational culture is often defined colloquially as the behavior that occurs when other people aren't watching. Cohn doubts rule breaking is explicitly encouraged on Wall Street. Rather, he said, “it is in the informal rules, not those spoken out loud.”

For several years, Mark Carney, formerly a Goldman Sachs managing director and the governor of the Bank of Canada, and now the governor of the Bank of England, has been at the forefront of an effort to change banking culture. In a speech in London, Ontario, in February 2013, Carney said the sacred trust among bankers, depositors, creditors, investors, regulators, and the public had been broken in the aftermath of the financial crisis. “Virtue cannot be regulated,” he said. “Even the strongest supervision cannot guarantee good conduct. Essential will be the rediscovery of core values, and ultimately this is a question of personal responsibility. More than mastering options pricing, company valuation, or accounting, living the right values will be the most important challenge” for those in the banking profession.

Carney described a fundamental change he had noticed in the banking ethos in the years leading up to the crisis. The relationship between bankers and their clients—once the bedrock upon which the industry was built—had been steadily eroding. “Banking became more about connecting banks with other banks,” he said. “Clients were replaced by ‘counterparties,’ and banking was increasingly transactional rather than relational.” Innovations such as credit-default swaps (whereby risk is packaged up and traded) and securitization (whereby mortgages and other assets are sold off as investments) went hand in hand with this shift. The conventional role of the banker as the person who unites borrowers and lenders, and knows both, disappeared into a world of unknown unknowns, as Donald Rumsfeld might say. “In most professions, people can see the ‘real’ impact of their work: teachers witness the growth of their students; farmers, that of their crops,” Carney said. “When bankers become disconnected from their ultimate clients in the real economy, they have no direct view of the value of their work.” That makes selfish and unethical behavior easier.

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Carney urged banks to include less cash and more stock in bankers' compensation, encouraging a long view. He recommended the use of “clawbacks”—the fine art of taking bonuses back if it later comes to light that particular bankers and traders acted in bad faith. But he also said that fixing flawed rewards systems would not be enough. “Integrity cannot be legislated, and it certainly cannot be bought,” he observed. “It must come from within.” Last year, at the World Economic Forum in Davos, he mentioned new financial scandals that had surfaced, such as those in the foreign-exchange and interest-rate markets. “Penalties for misconduct cannot be seen as a cost of doing business,” he said. “Only exemplary behavior can confer social license to global financial capitalism.”

Recently, other important regulators have begun to beat the same drum. Speaking at a May 2014 conference in London, Christine Lagarde, the managing director of the International Monetary Fund, said the ongoing scandals prove that banks have not gotten the message. “While some changes in behavior are taking place, these are not deep or broad enough,” she said. “The industry still prizes short-term profit over long-term prudence, today’s bonus over tomorrow’s relationship. Some prominent firms have even been mired in scandals that violate the most-basic ethical norms.”

This kind of talk has been loudest in Europe, and it has begun to inspire some action, however symbolic. In 2012, the British Parliament established the Commission on Banking Standards to make recommendations on how to improve the behavior and competence of banks and other financial institutions in the United Kingdom. Last year, bankers across the European Union had their bonuses limited to no more than twice their salary, in a new set of rules that supposedly reduce incentives to swing for the fences. And in the Netherlands, the Dutch Banking Association now requires that each of the country’s 90,000 bankers take an oath reading, in part, “I swear that I will perform to the best of my abilities to maintain and promote confidence in the financial-services sector, so help me God!” Jeroen Dijsselbloem, the Dutch finance minister, explained the policy to *The New York Times*. “Our Calvinist approach to life is that you have to work hard, to behave, be sensible about your money,” he said. “And the culture in the financial system sort of floated away from that.” Thanks to the tone set from the top by Carney and others—and thanks to the wholesale replacement of senior executives at some of Europe’s biggest banks—European financiers have been exposed regularly to a new evangelism, and at least a few seem to have found religion, trying to instill in their profession a renewed sense of morality and ethics.

On this side of the Atlantic, the problem of banking culture has been less of a priority, and only recently came clearly into focus for key officials. Last October, William Dudley, the president of the Federal Reserve Bank of New York, weighed in during an all-day, closed-door “workshop” that the New York Fed hosted for finance-industry insiders on the topic of reforming Wall Street culture. Dudley, who in a 2013 speech had mentioned the problem in passing, addressed it squarely this time. He noted that there had been, in recent years, “ongoing occurrences of serious professional misbehavior, ethical lapses, and compliance failures at financial institutions,” adding that although these scandals had prompted plenty of fines—more than \$100 billion, in fact—they had resulted in the prosecution of individual bankers and executives “to a lesser degree than I would have desired.” Wall Street, he said, “has largely lost the public trust.” Changing its culture was “imperative.”

Culture, Dudley said, “relates to what *should* I do, and not to what *can* I do.” He reiterated several of Carney’s central themes: Wall Street’s compensation system rewarded bad behavior and had a misplaced focus on “counterparties” rather than on clients. It fell to top executives to fix the broken culture, he said, and fast. “Senior leaders need to hold up a mirror to their own behavior and critically examine behavioral norms at their firm.” Yes, he said, Wall Street regulators must be more vigilant, but the truth is that the watchers will always be outgunned by the watched. That’s why Wall Street needs to act on its own. “If those of you here today as stewards of these large financial institutions do not do your part in pushing forcefully for change across the industry, then bad behavior will undoubtedly persist,” he concluded. “If that were to occur, the inevitable conclusion will be reached that your firms are too big and complex to manage effectively. In that case, financial-stability concerns would dictate that your firms need to be dramatically downsized and simplified so they can be managed effectively.”

And then he repeated that point: “It is up to you to address this cultural and ethical challenge. The consequences of inaction seem obvious to me—they are both fully appropriate and unattractive, compared to the alternative of improving the culture at the large financial firms and the behavior that stems from it. So let’s get on with it.”

It was good theater. But the speech’s impact remains to be seen. Although Dudley’s remarks were released to the public, the workshop itself was closed to ordinary citizens and to the press. (He declined to be interviewed for this article.) Goldman Sachs and JPMorgan Chase, perhaps the two most influential banks on Wall Street, sent high-ranking representatives to the meeting, but not their CEOs, Lloyd Blankfein and Jamie Dimon.

Both of these firms have recently acknowledged some past excesses. In December, JPMorgan waded into the Wall Street culture debate with a 100-page report, “How We Do Business,” following a request from a shareholder group, led by the Sisters of Charity of Saint Elizabeth, that the bank explain itself in the wake of recent scandals. In true Alcoholics Anonymous fashion, the firm admitted that it had made mistakes and took responsibility for them. “During the past several years, we have faced a series of legal and regulatory issues,” it said. “In some cases, our controls fell short, and in others, we simply weren’t meeting the standards we had set for ourselves. We know we can do better and are committed to doing so.”

Goldman issued its own report back in 2011, recommending 39 ways the firm could change for the better. Its executives argue that they have actually begun to change, in small ways, the business Goldman chooses to do, in a concerted effort to avoid participating in deals that might damage its reputation. One example is Goldman’s promise that it will not underwrite or sell European “contingent convertible” bonds to unsophisticated investors, even though its competitors do. Meanwhile, JPMorgan has stopped serving most foreign embassies and scaled back its business with “correspondent” banks that provide services to other banks, not because there is inherent wrongdoing involved but because the bank cannot easily track how these organizations use the cash.

Yet neither Goldman nor JPMorgan has shown much interest in abandoning their most important lines of business. For Dimon, at JPMorgan, bigger remains better, despite recent suggestions that the bank be broken up (including in a research report by a Goldman analyst). He says the firm’s clients want it to be comprehensive in its services and global in its reach. And he’s certain that will be good for business as companies continue to grow. Goldman hasn’t changed much either. Despite hearing criticism from many quarters about the systemic threats posed by some of its risk taking, it has not significantly reduced its reach. Just as before, it is still a dominating force in investment banking, trading, private-equity investing, and money management. There have been a few minor shifts—its risk-arbitrage desk was off-loaded in 2010, and in late 2014 it sold its aluminum-warehousing business—but Goldman has proudly, and confidently, maintained its belief that modest change is all that is necessary in the aftermath of the worst financial crisis since the Depression.

And what of the billions of dollars in fines that firms have collectively paid in recent years to supposedly atone for their prior bad behavior? Against their more than \$150 billion in collective annual profits, these fines really can look like a cost of doing business, quietly absorbed by shareholders, not individual bankers, traders, or executives.

The only CEO of a major Wall Street securities firm who attended Dudley’s October extravaganza was James Gorman, the 56-year-old McKinsey-trained chairman and CEO of Morgan Stanley. His presence made sense: since he took over as CEO, in 2010, no Wall Street firm has done more to transform its own culture and business. The centerpiece of Gorman’s strategy has been to double the size of the firm’s business managing people’s money, which generates predictable annual fees, and to deemphasize the swashbuckling, risk-taking bravado that had been the signature style of his predecessor, John Mack. Out went the proprietary traders and in came the wealth managers. At the end of 2014, Morgan Stanley employed more than 16,000 brokers and managed more than \$2 trillion in assets, making it one of the largest wealth-management firms in the world. (In the past year, I have twice given paid talks to groups of Morgan Stanley brokers.)

In an effort to reduce its risk taking and to more fully comply with the spirit of the Dodd-Frank Act and its Volcker Rule, which essentially required Wall Street to jettison its proprietary trading activities (that is, the financial bets made by the firms themselves), Morgan Stanley scaled back its commodities business and has been shopping its oil-storage-and-trading business. The firm has also reduced the amount of capital that individual traders have at their disposal, attempting to avoid a repeat of the situation that occurred in 2007 involving Howie Hubler, a trader who made a proprietary bet that ended up costing Morgan Stanley about \$9 billion and helped put it on the path to near-ruin.

Morgan Stanley’s born-again approach to banking started, it seems, during Gorman’s 2012 visit to Davos, where he explained why for the time being he was cutting senior pay, increasing deferred compensation, and limiting the cash portion of his firm’s bonuses to \$125,000 per person. Only on Wall Street could this

decision be considered contemptible, and yet he found himself having to defend it. “The world has changed,” Gorman said in an interview on Bloomberg TV. And to those at his firm with objections, he had some simple advice: “You’re naive. Read the newspaper, number one. Number two, if you put your compensation in a one-year context to define your overall level of happiness, you’ve got a problem which is much bigger than the job. And number three, if you are really unhappy, just leave. I mean, life’s too short.” (Many traders in fact have left the firm as a result of lower pay, long-deferred stock compensation, and the threat of bonus clawbacks.)

Ruth Porat, Morgan Stanley’s chief financial officer (who has now left the firm for a similar post at Google), recently described for me the many ways that Gorman has transformed the 80-year-old firm. “We’re a fundamentally different firm than we were seven years ago,” she said. Morgan Stanley has more capital, less leverage, and a better handle on the daily risks it takes than it did in 2008. “Our view was ‘You know what? We just lived this near-death experience. We’re going to make significant changes.’” In the wake of the Hubler fiasco, Morgan Stanley, like most other Wall Street firms, found itself heading toward oblivion in September 2008, rescued, in the end, only by \$9 billion of equity from a Japanese conglomerate and by the Federal Reserve’s decision to allow it to become a bank holding company. The “significant changes” Porat spoke of meant divesting some high-risk operations, but she also meant the way Morgan Stanley conducted business.

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“We’re in the risk-taking business,” Porat told me. “Just no outsized risks. You can’t do that to an institution. It’s irresponsible.” As at other big Wall Street firms, regulators from the Federal Reserve and the Office of the Comptroller of the Currency now have offices at Morgan Stanley, and Porat said they meet with her team on a regular basis: the days of the “light touch” regulatory approach are over. Instead, Washington regulators have ongoing access to Morgan Stanley’s loan and trading portfolios, and even attend portions of Morgan Stanley board meetings. “They can go wherever they want whenever they want,” Porat said of the regulators. But the firm also tripled the size of its own team that analyzes risk and put strict limits on the amount of risk that can be taken. And in its promotion decisions—particularly those involving leadership roles—it seems to be placing a higher value on collegiality and effective management than on star power and rainmaking. (A notable example is the 2012 selection of Colm Kelleher over Paul Taubman—a hugely successful deal maker who subsequently left to start his own advisory firm—as the sole head of Morgan Stanley’s institutional-securities business.)

Porat said the tighter controls have made Morgan Stanley a better firm. “If you want to be a hedge fund, go be a hedge fund, but there’s a place and a role that we each play in an ecosystem. And that’s the approach that we’ve taken.”

Proprietary trading and other risky activities have a place in finance, and can make the system more efficient in its allocation of capital. The question is whether these activities should have a prominent place within huge, multipurpose banks that are essential to the economy’s basic functioning, or restricted to smaller firms, ideally ones owned by their own partners. A key debate among Wall Street executives these days is whether postcrisis regulation will eventually force big banks to operate more like utilities—providing capital as reliably and cheaply as electricity or water—or whether dynamics will soon return to what they were before all the upheaval. Morgan Stanley, seemingly alone among its peers, believes the changes that have already been made are largely permanent, and that they should be. And it has rebuilt its business accordingly. Whether its bet will pay off is a question preoccupying the top executives of other Wall Street firms. Many are watching the Morgan Stanley experiment with a mixture of skepticism that the bank is wrong and trepidation that it is right.

This is not the first time Morgan Stanley has tacked toward a more conservative business culture. Gorman’s strategy is not dissimilar from the one embarked upon around the turn of the millennium by John Mack’s predecessor, Philip Purcell, another former McKinsey consultant, who was one architect of Morgan Stanley’s 1997 merger with the brokerage firm Dean Witter, Discover & Co. Like Gorman, Purcell reduced the firm’s

risk taking and added a formidable layer of predictable earnings to its bottom line by managing people's money for a fee. Along with the politics of the merger itself, Purcell's leadership angered Morgan Stanley's old guard so utterly that in 2005, they engineered a coup to get rid of Purcell and to bring in Mack, who had spent nearly 30 years there, holding various leadership positions, before leaving and joining Credit Suisse. Purcell left Morgan Stanley in good financial condition, with a healthy balance sheet—in fact, looking very much like the utility that some regulators now envision Wall Street firms becoming—but he is still persona non grata around the firm. *The New York Times* recently reported that he did not attend its 75th-anniversary gala, in 2010, at the Metropolitan Museum of Art, and that his portrait is not among those of CEOs hanging on the executive floor. Mack's loose style and enthusiasm for risk very nearly bankrupted the firm; he is remembered fondly, though, for his gregariousness and devil-may-care attitude.

Culture is a hard thing for any organization to change, and reforms that run against a long-standing ethos—especially those that emphasize restraint—can be fragile and reversible depending on the nature, character, and ideas of the next CEO who walks in the door. Vikram Pandit, the CEO of Citigroup during and after the financial crisis, spent years trying to reform the culture at his firm—and not always successfully. “Culture does make a difference,” he told me recently. “On the other hand, building a culture takes years. I think we made a big difference at Citi, but we certainly weren't even close to getting it done in the five years that I was there.”

Gorman's efforts may prove more enduring than Purcell's. His approach has surely been given some formidable wind by the intensity of public opprobrium toward Wall Street since 2008, by the regulations that have made Wall Street's riskier businesses less profitable, and by the fact that Morgan Stanley's strategic turn has been a qualified success. While the firm's reported profit last year was substantially lower than JPMorgan's (\$6.2 billion compared with \$21.8 billion), its stock rose nearly 24 percent in 2014, making it one of the best performers among Wall Street banks.

The rank-and-file bankers and traders who have remained with the firm seem, for now, to be on board with the new ethos. One longtime Morgan Stanley banker traces a cultural turning point back to Gorman's comments in Davos in 2012. Bankers “just get into the habit of complaining about compensation and sort of thinking that they're entitled to be paid 50 times what a firefighter that runs into a burning building to save a little baby gets paid,” the banker told me. “That entitlement is sort of endemic within banking.” (Senior bankers and traders typically make at least \$1 million these days and often much more.) When Gorman questioned that presumption publicly, he “said what a lot of people actually felt, and to be honest with you it was kind of refreshing.” Those who couldn't cope with the new regime are long gone, but most people stayed, knowing that even the reduced pay on Wall Street these days is far greater than what they're likely to earn nearly anywhere else.

Of course, Morgan Stanley is just one firm. Gorman declined to be interviewed for this story, in part, his handlers told me, because he did not want to be seen as having the right answer for the industry as a whole, or as being preachy about what needs to change. More-expansive leadership on Wall Street will need to come from a different source. In the meantime, regulators will try to keep the industry's worst tendencies in check, through a combination of jawboning and regulation. In January, Thomas C. Baxter, the executive vice president and general counsel of the New York Fed, gave a speech at the Bank of England titled “The Rewards of an Ethical Culture,” in which he noted the importance of an organization's “cultural character” being set from the top. In February, the White House announced its support for the Labor Department's proposed rules designed to make sure Wall Street brokers treat their clients ethically and do not sell them high-fee products that are wrong for them as they prepare to retire. (Amazingly, as of now, many Wall Street “financial advisers” have no formal fiduciary responsibility to their clients.)

Perhaps we really are nearing the time when Wall Street bankers, traders, and executives will decide they have no choice but to change their behavior. Having worked in banking for 17 years and reported on it for another 11, I certainly detect a slightly humbler and more reflective tone coming from the corner offices of Wall Street skyscrapers these days. What's less clear is whether executives really mean to change or whether they are just afraid of change being imposed upon them by the likes of William Dudley and Mark Carney. The fact is, it's hard to tell whether people on Wall Street are making money for their firms honestly or by

cutting corners. That latter behavior is usually discovered only after a crisis, once subpoenas have been issued and e-mails and other revealing documents have been made public. Is the rising talk of cultural reform reflective of something genuine, or just so much hot air? The question would be nothing more than an academic exercise if the outcome weren't so damned important.

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