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Strategic human resources and governance in banking

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ABSTRACT

The importance of human and corporate governance, crucial to all serious undertakings, is particularly critical in the fields of finance and business. Banks and other financial institutions play a key role in a nation's economy, and also have global implications for growth and prosperity. The abuses of the financial system, vividly illustrated in the 2008 crisis, reinforce the need for improved conduct and corporate governance among financial institutions, in which the Human Resources (HR) function, by virtue of its expertise, should play an enhanced and influential part. This summary paper argues for a strengthening of the HR position, emphasising greater independence and more elevated reporting lines. It is the HR experts who should know better than most management in a bank how human foibles contribute to abuse of the system and how to mitigate them. In this way banks can more quickly win back the public trust they have lost in large measure.

KEY WORDS

human resources, corporate governance, banking

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1 INTRODUCTION

Financial experts, both academics and practitioners, should recognize that finance is not a science (despite attempts to base financial market behavior on mathematical models). While theoretical frameworks can provide a useful basis for explanation of financial market phenomena, this is just a starting point. The financial crisis of 2008 illustrated starkly what an ineffective job these models did in attempting to predict market behaviour under extremely stressed scenarios. Even in more normal situations, the human element plays a dominant role in market and investment performance, as well as in organisational behaviour (Statman, 2010).

The burgeoning field of behavioral finance borrows from human psychology (the domain of HR) in helping to explain financial market behavior and conduct. As human beings, we are not always rational, but are subject to a number of unconscious behavioral foibles that fly in the face of logic. Sophisticated market practitioners increasingly observe this, and use it to their advantage, not always in the most ethical way. The increasingly complex world of finance (and business) naturally lends itself to exploitation, deliberate or otherwise, of less sophisticated participants (Davis et al., 2016).

This emphasizes the importance of consistently and transparently applying principles of proper human and corporate governance, whether in dealing with clients, employees, shareholders, or other stakeholders. Most effectively run firms today have adopted sound principles of corporate governance, which must start by example from the top, and permeate the entire organization. These principles should be reinforced by a published code of conduct, clearly laying out the mission, vision and expected behavior of participants in the firm, along with sanctions to be expected in the event of violation. While these precepts should be understood by all staff, the HR function should regularly be playing an active role in promoting proper behaviors. Simply having a code and published principles is not enough. They must be consistently observed and applied in practice (Enron, for instance, had a code of conduct running to 64 pages; Spector, 2003).

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Aside from HR, other practitioners, and those of us teaching finance and business in the classroom, ought at every opportunity to emphasize the duty of those seeking to make a career in the industry to act fairly, openly, honestly and transparently with stakeholders. Financial activities, like many others, inevitably give rise to ethical dilemmas, and an essential part of a pedagogical and mentoring approach is to try to impart ways to manage such dilemmas in order to achieve the best and fairest outcome for all concerned. This can be done by utilizing case studies and real life experiences that the proponent or colleagues have been involved in (Bace, 2014). A financial or business education or experience that does not incorporate this all important aspect of professionalism into its training is ultimately lacking, and perpetuates the unethical behaviour that we read about all too often, not only in business, but in any profession you can imagine. It is not sufficient simply to impart the theories, knowledge and technical skills to make someone successful in a career, but the overwhelming importance of integrity is what makes a true professional, on individual, organizational and societal levels.

2 THE HUMAN RESOURCES FUNCTION

Given their expertise, the HR function of a financial institution, like any enterprise, profit-oriented or non profit, must be charged particularly with reinforcing these concepts, alongside other employees. Their role is not simply to act as a tool of management, hiring and firing based on management dictates, but on the contrary and above all helping to instil principles of excellent customer service, professionalism and integrity, in a proactive fashion, and by setting the example themselves. Like any other employee, HR experts should also be forthcoming to management in observations about the corporate culture and behavior, which may require correction, both on upper levels and lower levels of seniority. One can argue that HR is uniquely positioned to carry out this role, given their theoretically wider view of the organisation as a whole, and their understanding of human psychology (Wood, 2009). Admittedly, such proactivity requires courage and resilience, but if HR professionals do not include this in their work activities, they are ultimately shirking their responsibilities. It should be an objective of HR not to shut down legitimate whistle blowers, as management may often wish them to do (as in the recent case of Barclays; Binham, 2018), but in fact to encourage this feedback loop, and to participate in it themselves.

This may give a new definition to the HR function, who are so often seen just as gatekeepers and instruments of management. If senior management is not setting an appropriate tone, is it right simply for HR to follow along with it? Nor should corrective actions be implemented only because the regulators (and customers) demand it, but because it is the right way to carry on business, to encourage an open, customer focused enterprise. The process must be seen not as one of simply compliance and financial performance. This is the best way for banks and other companies to prosper, since if their employees and customers are satisfied, this will engender customer and employee loyalty and company success.

3 CORPORATE GOVERNANCE

Good corporate governance, incorporating corporate social responsibility, requires that robust processes are in place to mitigate risks and encourage proper behaviors. Corporate governance is "the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meetings" (FRC, 2016).

A proper corporate governance scheme demands an effective HR function, among a multitude of other functions, all working in pursuit of the firm's performance as well as its responsibility to society and stakeholders. We observe a correlation between firms with poor corporate governance and underperformance of such companies (Bhagat & Bolton, 2007). Corporate governance among banks takes on even more importance given not only their systemic importance but also their multiple stakeholders, including shareholders, customers, depositors, regulators and governments.

In the wake of the 2008 financial crisis, regulators and supervisors in developed nations have increasingly called for improved standards of conduct among banks, particularly in the UK and continental Europe (FCA, 2013). The US has implemented legislation to try and address the issue, which unfortunately more recently shows highly disturbing signs of being rolled back (Warren, 2018). This reform extends beyond banks and financial institutions to internal audit and other industries and firms associated with their activities, such as accounting, tax, legal and audit firms. It remains to be seen in many cases whether the most influential part of the equation, the governments, reinforce consistently the reform effort, through legislation or other means, or remain unduly swayed by the political dimension over principles of justice and fairness.

4 HUMAN RESOURCES AND THE ORGANIZATION

If we define strategic human resource management (SHRM) as "an approach to managing human resources that supports long-term business goals and outcomes with a strategic framework… focusing on longer-term people issues, matching resources to future needs, and macro-concerns about structure, quality, culture, values and commitment" (CIPD, 2017), then we must first understand the goals of the organization. A take no prisoners aggressive hedge fund, for instance, may be more likely to charge its HR unit strictly with hiring and firing, doling out bonuses or penalties, and other such mechanistic activities, if it has an HR department at all. On a more normal level, however, the strategic component in HR is determined both by the relation among HR practices and business strategy, and the impact of such practices on company performance (Delery & Shaw, 2001). Prior studies have identified a positive link between proper deployment of SHR and firm performance (Simon, 2007). Firm performance is not to be measured simply in financial terms, but also importantly in other more intangible terms such as customer and employee satisfaction (Choudhry, 2012).

Where we observe, among publicly listed companies, including banks, underperformance relative to peers, this can often be put down to a misalignment of goals and objectives among employees. Every well governed organization should have an appropriate mission statement, articulating the values and aspirations of that organization, to which all stakeholders subscribe. From this mission statement flows a group of goals and objectives, well understood by all employees, in order to align their activities to meet those goals effectively. Strategies are then developed to work towards and achieve those goals (Deloitte, 2009). These strategies should also be well disseminated throughout the organization. Finally various legitimate tactics can be employed to further those strategies, which will often be undertaken on a more micro level, down to individual business units. The ultimate goals and mission, however, should not be lost sight of in this process.

Given that HR is typically charged with employees' well being in an organization, they must play a key and proactive role in helping to disseminate understanding of the mission, values, goals and strategies of the firm, and taking corrective measures where necessary. In the past we have seen too many examples where HR was more concerned about compliance issues than building leadership capabilities and other human capital factors (Beatty et al., 2003). At a time when the vast majority of banks, especially in the US and UK, are still highly mistrusted by the general public, this brings the problem into a sharper focus (Edelman, 2018). HR can make a real contribution to turning around the huge tanker by re-orienting the perspective from a compliance exercise, based on senior management instruction, to an active role of cultivating future leaders and employees who are in touch with all the stakeholders. In this of course they require the support of senior management and the board.

Who are the ultimate clients of the HR Department? Is it senior management? Is it the employees? One can argue it is not only both of those (with an emphasis on the latter), but also a wider group of stakeholders, in whose interest all of the above organizational units should be acting, if true alignment exists. HR should be active in helping to break down silos within the organization (and not exist within its own silo), in making and implementing recommendations to improve transparency and accountability, and to act as effective intermediaries between business units and levels. It is to be argued that the HR Department in a bank bears the same fiduciary responsibility to shareholders as does senior management and other employees. If they are not acting in the best interests of shareholders (and ultimately customers), they are breaching that responsibility. Moreover, the most important asset arguably of a bank is its people, the careful nurturing of whom falls in large part to the HR function.

5 CONDUCT AND COMPLIANCE

While not claiming to be an HR expert by any means, it seems to me that a primary function of HR is to promote the highest levels of ethics and professionalism within the organization. The very term "human resources," especially in an industry such as banking, implies maximizing the capabilities of employees in an ethical framework which forms the basis of proper human behavior. In many organizations, not just in banking, there all too often seems to prevail an atmosphere of distrust, even fear, between HR (as tools of management) and employees. If bank employees do not trust their own HR Departments, how can banks expect to win back the trust of the public? In such an atmosphere it is easy to form the impression that HR is reflecting the "tone from the top," promulgating an atmosphere of fear and distrust, where the opposite should be the case. Who would like to be a genuine customer of a firm that is not trusted by its own employees?

If we look at HR in more innovative companies, we can observe that their role is much more one of nurturing talent and creativity, rather than the hard edged approach of giving penalties or rewards to employees who do not completely toe the line (Diaz-Fernandez et al., 2015). This is not to say that egregious transgressors must not be disciplined, but in today's environment a more flexible approach is needed, in contrast to the traditional rigid corporate approach. A few years ago I was once told by HR, after spending a year in a state owned financial institution in London, and made redundant, on grounds that were not clear to me, that "we don't have to tell you why we are letting you go." Is this a good formula for the long term success of an organization, private or public?

In this summary paper, we are suggesting that involving HR more closely in promoting corporate governance will benefit banks and financial institutions, their stakeholders and the economy as a whole. Observance of good corporate governance propels good corporate performance and excellence. Further benefits are gained through higher and more motivated employment and financial system stability. Since banks which otherwise would have suffered prosper instead, the employee base remains loyal and intact, and the system stays sound. Employees are more dedicated in a setting where their rights are respected. This in turn helps to ensure that public confidence (without which no bank can survive) is raised through appropriate disclosure and maintainence of high ethical standards and professionalism.

6 HR AND ETHICS

HR experts have to play an active role in building an ethical banking organization in line with codes of corporate governance, which they should be involved in compiling. HR experts should be elevated to higher positions of power and influence within banks, and apply their special qualities to help build leaders and careers in the industry. Banks demonstrating high ethical standards are more likely to reach their strategic goals, are viewed more positively by their stakeholders, and are better positioned to attract and retain human talent. Under the leadership of Stephen Hester and others after the disastrous example of Fred Goodwin, RBS, for instance, has been making efforts in this direction, not with the greatest success (Martin & Gollan, 2012), which illustrates how challenging this process can be. To cite Barclays again, the departure of CEO Bob Diamond at the instigation of the regulator (Jenkins, 2012) was precisely the symptom of a misguided corporate culture, which the bank has apparently not made significant progress in changing.

Nonetheless HR is obliged to devote more attention and effort to assessing honesty and integrity of the company's decision makers. In some cases, these evaluations may result in termination, or lack of promotion, or lower compensation. In other instances, they may lead to imposition of additional controls. Nonetheless, assessments must occur and be thorough, ongoing, and all encompassing. It may be hard to believe that many top bank executives who fell foul of regulators and the law misbehaved for their entire careers without no one (even HR) noticing. Fraudulent bank officials were likely not always ill intentioned. Instead, as they regularly brushed against legal and ethical boundaries, they discovered they had crossed the line without even knowing, if not for the regulators. HR professionals are obliged to keep the bank executives from approaching the boundaries, and to speak up as soon as they are crossed, if not sooner, in the interests of shareholders and all other stakeholders, and in line with professional conduct. This should result in a more sustainable banking business model, building confidence among customers and employees and resulting in greater financial stability.

7 HR AND COMPENSATION

HR's role in remuneration of executives is also increasingly significant. A competent HR unit ought to have superior knowledge to anyone else in the bank of the effects of incentives, both positive and negative. Yet, given the prevailing scandals and continuous negative press, one questions where HR is to be found. We realize that linking pay to any performance measure has the potential for negative consequences, and stock compensation is no different. Did the huge amounts paid to executives ever appear to HR as something that might potentially pervert decision making? The argument is not that stock compensation should be excluded, that executive pay is excessive (although it tends to be), or that CEOs should be prohibited from earning external income. However, it seems that in most instances, such fundamental questions were never even asked. HR executives were likely either bought off (with their own big pay packages), implicitly (or explicitly) threatened (with firing or some other penalty) or simply ignorant of the situation. Nonetheless, this reinforces the duty of HR professionals, who should have the competence to recognise consequences of incentive systems, and the courage to speak up where they see danger.

As reward management experts, HR plays a critical role in risk/reward management and governance, and must not simply follow the status quo, where their role has often been peripheral to corporate governance issues. To contribute effectively, HR must work closely and win credibility with other key stakeholders, particularly the board and senior executives. It is incumbent on HR to build a collaborative relationship with the board, especially remuneration committees, ensuring in particular that there is a formal and transparent procedure for developing policy on executive remuneration. It has often been observed that the compensation of directors and management have no link with their abilities and performance (Li & Young, 2016). Participation of shareholders in pressuring boards to formulate and disclose board remuneration is also to be encouraged. Good corporate governance dictates that compensation of executive and directors should be transparent, fair, and reasonable.

8 EXTERNAL STAKEHOLDERS, HR AND THE BOARD

The choice and management of auditors and tax consultants is likely also not something that has been of the greatest interest to HR. In addition, HR seems to have little influence over choice of board members. However, the scandals in banking should provide more than adequate incentives for HR to broaden its view of where it is to be involved. Who within the firm has better understanding of such incentives, and how they can create conflicts? Just as they ought to note internal conflicts between analysts and investment bankers within their banks, they ought to be best positioned to identify potential conflicting incentives within different units of the bank. HR must also become more engaged in board member selection, with a focus not just on competence of the members, but those potential members' networks of relationships.

Moreover, HR can play a leading part in helping to direct processes for functioning of boards. Many firms now periodically evaluate their boards and board members, and rightly so. Many have begun requiring board members to receive training, even subsidizing this activity. Many have moved to having some board meetings without managers being present. The established competencies of HR, such as team building, group process, selection, training, performance management, and so on, are all critical to an effectively functioning board. Therefore, HR's role must expand to include these activities at the board level, not just at the organizational level. This is in line with best practices to strengthen bank governance structure, and encompasses factors such as optimal board size, selection of directors, and the mix of skills and experience to be represented on the board.

At the end of the day, effective corporate governance comes down to the performance of the board. The responsibility of governing a corporate entity is the board's raison d'etre. If the company is to be governed effectively, the board needs to comprised of the right people, each of whom must play their part responsibly in the firm. An effectively functioning board should be made up of members who are independent, skilled, knowledgeable, experienced and who represent different perspectives.

The traditional HR roles of strategic partner, employee advocate, administrative expert, and agent of change should not disappear, nor should they diminish in importance. However, the bank scandals and failures have added to these current responsibilities that of "integrity officer" (Wright, 2003). Some firms have often used HR professionals as their ethics or compliance officers (Davis & Carnovali, 2010), but this enhanced role goes beyond a mere structural arrangement. HR must actively and constantly scrutinize the environment faced by the top decision makers. They must accurately identify the pressures and the incentives that could push decision makers to put their own self interest above the organisation's interests, and to do so in a timely fashion. They must continually evaluate the evolving character of the decision makers, recognising that individuals who demonstrated high integrity, and may still aspire to such, can slowly and gradually slide down a destructive path. They must widen their focus on relevant organizational participants beyond the internal executives to include the auditors, consultants, investment bankers, and board members, and be constantly on the alert for potential conflicts of interest. Most importantly, at the first signs of unethical behaviour, HR must exercise the confidence and courage to explicitly, rapidly and specifically table it for top managers and/or the board, who should welcome and encourage such feedback. Many executives have described the HR function as the "conscience" of the organization (Beatty et al., 2003). While "conscience" ought to permeate all units of the organization, HR professionals must take this role seriously within banks. Such a role creates a tension that the industry must recognize and to which it must be responsive.

9 CONCLUSION AND RECOMMENDATIONS

Top HR executives are typically hired and fired by the firm's CEOs. When HR serves at the command of those they may be required to report on, how can they be considered sufficiently independent to be expected to do so? Therefore, this may call for exploration of changes in the employment relationship of top HR executives. HR ideally should have a direct reporting line to the board. Their employment contracts should include meaningful clauses of protection for those who may be at risk of being penalized for effectively playing this "conscience" role. We do not have the perfect answer, but we recognize that all the issues discussed above as potential causes of management misbehaviour can also characterise the positions of HR executives. Consequently, as the industry seeks to improve systems to encourage honest behaviour in senior management, it must at the same time examine its own situation to ensure the systems cannot be circumvented (Buyens & De Vos, 2001).

No one can legimately blame the problems which led to the banking crisis on HR alone. Clearly, misguided bank management and officials, with incentives to act unethically, working under inadequate controls and within a flawed system, were major contributors to the problems we still see today. HR did not directly cause these problems, but to say that HR was not the cause does not absolve it totally from responsibility. If steps are taken as suggested herein, it could help to avert or reduce likelihood of further corporate scandals. Therefore, HR must be vigilant, diligent and proactive to stem the tide and nip in the bud such practices that run counter to corporate governance best practice, in order to help mitigate the next serious crisis and financial scandal in the sector. As custodians of the firm's legal and moral obligations, HR must be wide-ranging and versatile, reinforcing good governance and helping to ensure each bank's strict adherence to the code of conduct by the bank's CEOs, senior management and employees at large.

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