Towards a 3-D model of risk management: Why is the current focus on culture, conduct and senior management having so little impact?

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Abstract Since 2008, regulators and risk professionals have recognised that culture and senior manager behaviour are critical drivers of fair treatment of customers and effective risk management. However, despite this recognition, cultures are slow to change, and regulatory and risk management failures at financial institutions continue. This paper argues that the paradigms adopted by regulators and risk professionals in addressing culture are flawed and that the rationalist, pseudo-scientific approach that underlies most risk management cannot control these fluid, sometimes chaotic and always complex factors. We identify some key indicators of effective cultures and highlight the challenges to risk departments, which must become expert in assessing organisational learning, management decision making and future thinking.

Keywords: *risk management, culture, conduct, regulation, banking, finance*

> 'They constantly try to escape From the darkness outside and within By dreaming of systems so perfect that no one will need to be good.'
>
> T. S. Elliot[1]

> 'Pursue a straightforward, upright, legitimate banking business. Never be tempted by the prospect of large returns to do anything but what may properly be done under the National Currency Act. "Splendid financiering" is not legitimate banking, and "splendid financiers" in banking are generally rascals or humbugs.'
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> Letter of guidance to bankers from the US Comptroller of the Currency, December 1863[2]

> 'Experience has demonstrated that poor culture and poor conduct are closely related.'[3]

In its business plan for 2016–17 published in April 2016, the UK Financial Conduct Authority (FCA) cites the theme of culture and governance as one of seven priorities for the coming year. Undoubtedly, many of the problems in financial services over the last decade have been either caused or exacerbated by cultural issues that are proving impossible to fix, as the 'groundhog day' repetition of poor treatment of customers demonstrates. This paper will explore the regulatory focus on

organisational culture and the behaviour of senior managers that has emerged as a key theme of regulators around the world since 2008.

We shall argue, however, that some of the thinking by regulators and their stakeholders about culture and senior management behaviour is flawed. The underlying rationalist and pseudo-scientific paradigm of global financial services regulation means that regulators are struggling to understand and impact culture and behaviour. This paradigm also finds its way into the compliance and risk management frameworks in banks and other financial institutions, leading to poorly thought through and executed improvement initiatives. We shall explore this and identify the characteristics of positive risk cultures that can help risk professionals when discussing culture with senior managers. Risk professionals need to have a greater impact on culture and prevent the poor decision making that can lead to the level of customer detriment, financial remediation and penalties that have plagued the industry in recent years.

THE ONE-DIMENSIONAL REGULATORY APPROACH TO CULTURE

In the aftermath of the global financial crash, pressure groups, media, politicians and regulators intuitively recognised that culture and management behaviour had been a major contributory factor in poor decision making and failed risk management. In some cases, this meant that firms and regulators did not identify weaknesses in organisations that would go on to be catastrophically impacted by the crash. Even more importantly, the suggestion was that in some firms, poor culture had actually driven and rewarded unacceptable risk taking and a disregard for customers.

In 2014, the Financial Stability Board of the G20 nations produced guidance for regulators on assessing culture in financial institutions:

> 'Weaknesses in risk culture are often considered a root cause of the global financial crisis, headline risk and compliance events. A financial institution's risk culture plays an important role in influencing the actions and decisions taken by individuals within the institution and in shaping the institution's attitude toward its stakeholders, including its supervisors.'[4]

The paper identified four driving factors within firm culture to which it recommended regulators pay attention: 'tone from the top', 'accountability', 'effective communication and challenge' within the firm and 'incentives'.

In the UK, we can see this mirrored in the thinking of the FCA. Former CEO Martin Wheatley said

> 'We know that if firms get it right at the top of their organisations then this has a tendency to flow down to create a good culture and outcomes for customers in the rest of their business.'[5]

Clive Adamson, former Director of Supervision, said in 2014:

> '… the right culture is essential, not through a fluffy view of vague corporate aspirations ... but more hard-edged embedding of business practices that define how decisions will be made at critical points of engagement with customers. Key drivers include clear and ongoing leadership … constant reinforcement, incentive structures, effective performance management and penalties for not doing the right thing.'[6]

In 2013 when Swinton Insurance was fined £7m and some of its senior management fined and barred for mis-selling insurance cover, the FCA Director of Enforcement said

> 'A culture was allowed to develop within Swinton that pushed for high sales and increased profit without regard to the impact on the firm's customers.'
>
> 'Those with significant influence within firms are responsible for setting the tone and the culture; they set the example that others will follow.'[7]

The furore over benchmark manipulation in large banks was attributed in large part to poor culture where, it was believed, reward schemes incentivised dishonest behaviour at the expense of customers and other market participants. Barclays and others made culture change one of the key planks of their remediation programmes.

Three key assumptions underpin the current regulatory thinking about culture:

(1) Culture is determined and driven by the actions of leaders and senior management.
(2) Reward and incentives are central in driving behaviour.

(3) Culture can be changed and drive improved behaviour, thinking and improved customer treatment.

We can now see this paradigm cascading into the work of risk professionals in the sector with a multitude of conferences and new services from the global consultancies targeting culture assessment and change. There seems to be a general recognition that prior to the crash, regulators and risk departments paid little attention to culture and behaviour, focusing instead on systems, controls and governance frameworks to place restraints on unfair practices, which was clearly not successful.

So why does the regulatory approach not seem to be impacting on cultures in the major banks and institutions?

CURRENT CULTURE PARADIGMS IN RISK MANAGEMENT

Regulators and risk departments do seem to be correct in their view that culture has played a large part in driving regulatory failures. In his 2013 research report Fixing Cultures in Financial Services[8] (sponsored by Enterprise Learning), the financial services specialist and economist Professor Amin Rajan reviewed FCA enforcement notices between 2010 and 2013 to identify underlying trends and driving factors.

He found a number of cultural factors underlying many of the enforcement notices. For example, he identified that an excessive cultural focus on short-term profitability was a common factor in many of the enforcement notices. He also identified a 'product driven' characteristic in many of the censured organisations and a minimalist culture regarding risk management and compliance (see Figure 1).

So, while flawed cultures undoubtedly drive poor behaviour and excessive risk taking (or at least do not help in their mitigation), why does the focus on this by regulators in the last decade seem so slow to take effect?

We can identify eight different ways of thinking about culture that are commonly found in risk management and regulatory frameworks (see Table 1). Each paradigm implies approaches to assessing, managing and changing cultures, but taken alone they are incomplete.

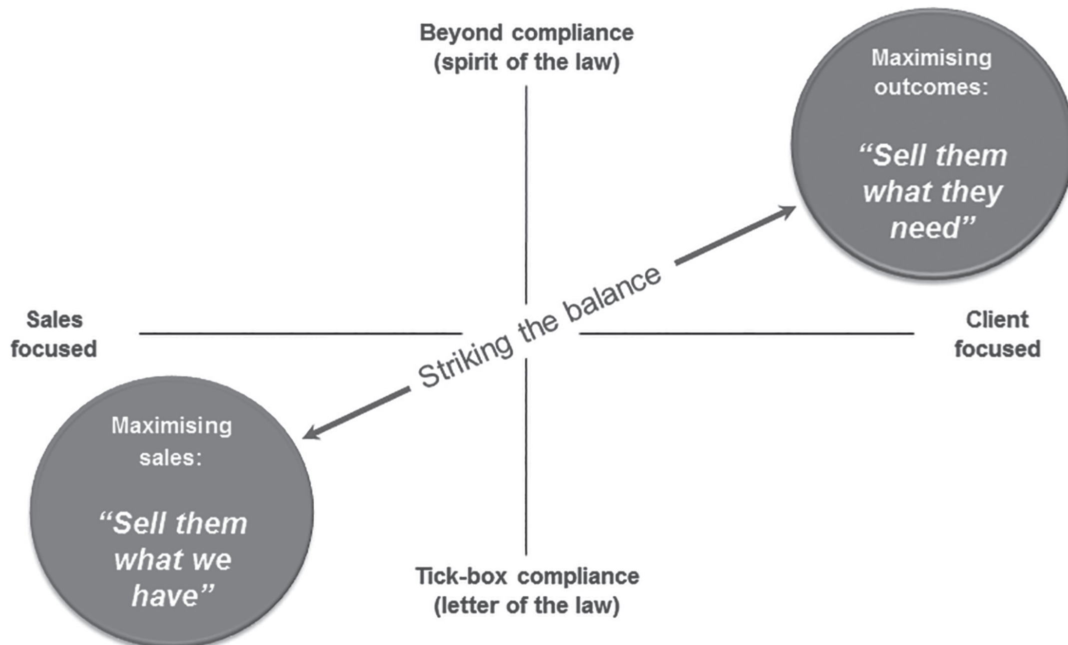

Figure 1: Unbalanced cultures, which lead to regulatory failure
Source: Rajan, A. (2013) 'Fixing cultures in financial services', CREATE-Research Ltd, Tunbridge Wells.

Table 1: Regulatory culture paradigms

Trickle down	Here, the fundamental view is that the leadership of the firm set the culture through their behaviour and words. It follows that the view is also that leaders can therefore adjust and improve culture. Culture 'trickles down' from senior management. This paradigm dominates current political and regulatory thinking and is one of the driving forces of new UK Senior Management Responsibilities regulation. Although undoubtedly true that senior management can influence culture and behaviour, it seems simplistic to believe that actions at the centre can determine the behaviours and cultures of large, often global institutions. This thinking also can lead to frequent changes in leadership in order to 'improve' culture, which often do no more than cause instability and continuous change initiatives.
Audit-based	Here, the view is that that independent audits (internal or external) can expose poor culture and management practice and therefore drive improvement. In the UK, the 'Three Lines of Defence' (3LD) oversight model embodies this, but it hinges on a rationalist and pseudo-scientific view of culture and behaviour that is at odds with most reality in large organisations. Despite the 3LD model being relatively developed in most banks for nearly two decades, most large regulatory failures have not been prevented by it and, indeed, hindsight has often shown that many of these organisations had been subjected to audits that failed to uncover the weaknesses, which then resulted in failure. Even more fundamentally, the pervading model of financial services regulation implies that central regulators can 'uncover' poor practice and culture through their audits and supervision, something that the crash of heavily inspected banks would seem to challenge.
Principles-based	This is the view that a framework of controlling principles can determine cultural direction and support decision making. Principles rather than rules are thought to provide flexibility so as not to be a constraint on innovation and management thinking and not to impose inappropriate controls. Managers and professionals, it is thought, will develop their own controls and practices in line with these guiding principles. The downside of this approach, as was seen with the principles-based regulation of the UK FSA, is that it can lead to confusion and a lack of clarity over what is and is not acceptable, which in turn can lead to wrong judgments and decisions. Again, the review of enforcement actions by Amin Rajan showed that many of the organisations that suffered enforcement and sanction nevertheless seemed to comply with the principles-based Treating Customers Fairly (TCF) and Approved Persons regimes in the UK.
Carrot and stick	Another rationalist paradigm that is prominent in regulatory and public policy is the view that culture and behaviour can be regulated by incentives and dis-incentives. Although it is true that deliberate mistreatment of customers or market manipulation is sometimes driven by skewed incentive structures, it is less clear that adjusting reward and accountability frameworks can prevent these. Increasingly, very punitive reward structures are being created in which mistakes or breaches can lead to loss of bonuses or earnings, particularly in already low-paid operations such as contact centres and bank branches. The danger is that this exacerbates the 'what's in it for me' culture in which staff will only do what is rewarded. Managers work within the very narrow confines of their job description and targets, which itself can also lead to customer disadvantage and detriment.
'Systems thinking'	Here, the view is that culture is predominantly the result of interconnected systems, policies and practices, which, if well designed and governed, drive a positive culture. Adamson's statement about culture (quoted earlier) reflects this. The organisation is a system, and if the components are well designed and monitored then culture can be regulated. Again, this rationalist view has some basis in reality, but it is questionable how much this can be achieved in fast moving, competitive and complex organisations where policies and controls become outdated as soon as they are launched. We see the exponential growth of policy and procedure in a fruitless attempt to pin down and control risk. This model can lead to constant and confusing change, which can impact negatively rather than positively on culture and behaviour.
Values driven	Similar to the principles-based model, but here the belief is that a common set of values can be 'rolled out' throughout the organisation and lead to a self-regulatory culture. An industry of values initiatives, HR consultants and workshops has grown up, but there is little evidence that it is possible to change personal values systems, which are often laid down early in life and determined by family and education. Many employers realise, after years spent on these initiatives, that more effect can be gained by improving recruitment and selection to focus on the core values of candidates, as well as their competence and experience.

In his book 'The risk management of everything' in 2004, Michael Power of the London School of Economics suggests that the dramatic rise in concepts of risk and risk management across Western society demonstrates a flawed belief that the uncontrollable can be controlled.

> 'On the one hand there is a functional and political need to maintain myths of control and manageability, because this is what various interested constituencies and stakeholders seem to demand. Risks must be made auditable and governable. On the other hand, there is a consistent stream of failures, scandals and disasters which challenge and threaten organisations, suggesting a world which is out of control and where failure may be endemic, and in which the organisational interdependencies are so intricate that no single locus of control has a grasp of them. Risk management organises what cannot be organised, because individuals, corporations and governments have little choice but to do so. The risk management of everything holds out the promise of manageability in new areas. But it also implies a new way of allocating responsibility for decisions which must be made in potentially undecidable situations.'[9]

Power describes how a false belief that a rationalist risk management and audit culture can protect organisations and individuals in the modern world in fact creates dangerous illusions of certainty and misplaced trust. The public largely trusted that regulated institutions could not mistreat them, even when selling products and advice that to most people were too complex to understand. Even more importantly perhaps, managers trusted that audited business practices and systems were 'safe' and therefore failed to keep them on their management agenda. The psychology of the 'green' rating driving leadership complacency is well understood in risk circles.

After 2008, much changed. Trust in regulation and regulated institutions (banks, car manufacturers, utilities, the BBC, the NHS, government) has largely been replaced by healthy scepticism or unhealthy cynicism. Public distrust of banks and institutions has grown to the extent that they turn to them increasingly less for advice. The public has developed an intuitive understanding that rationalist rulesets cannot regulate institutional cultures, but the regulators themselves, risk management departments and the large audit firms persist with these models. Although they help identify, mitigate and control emerging risks, they struggle to impact broken cultures, and the millions spent since the crisis have not stopped regulatory failures recurring, even in banks which apparently should have learned most from previous failures.

In July 2015, the report 'Banking conduct and culture: a call for sustained and comprehensive reform'[10] published by the G30 Group of American financial services movers and shakers also identified banking culture as critical in regaining the trust of bank customers and employees. It identified 'a culture of individualism and short-termism', 'weak risk culture' and 'a weak culture of oversight among Board members' as the main failures.

HOW CAN DAMAGED CULTURES BE REPAIRED?

The risk management paradigms described above cannot be abandoned. All have their place in the management and governance of our institutions, but they are necessary and not sufficient. What are the missing dimensions that can impact damaged cultures and rebuild trust in financial services? What should risk management, compliance, external and internal auditors focus on and develop their understanding of? The following factors should be high on the agenda of risk managers and regulators.

A culture of management curiosity, ethical decision making and management education

Flawed management decision making is often at the heart of regulatory failures and customer detriment. This is not about understanding right or wrong: the majority of leaders have a clear moral compass, a passion for achieving success and beating their competition in treating their customers well. They understand both the commercial and moral imperative for improving performance. Only a small minority of the thousands working in financial services deliberately mistreat their customers or

exploit weaknesses in their organisations for their own gain.

The difficulty most leaders and managers face is the complexity of the decisions and dilemmas they face daily. In 'How good people make tough choices',[11] Rush Kidder, founder of the American Institute of Global Ethics, suggests that the most difficult decisions faced by leaders today are not decisions of right versus wrong but rather of 'right versus right'. He highlights dilemmas faced daily by managers and leaders in which they have to grapple with balancing positive outcomes for different stakeholders. For example, in today's world, reducing branch footprints in retail banking can have a positive impact on costs and profits and drive online services from which many customers benefit. Equally, it can disenfranchise many customers who value and need a local presence. Increasing the price and margin of a product will increase profitability and perhaps keep employees working in an unstable insurance division. What is the answer to these dilemmas?

The best leaders are relentlessly curious and have excellent situational judgement. William C. Dudley, President of the Federal Reserve Bank of New York, addressing a forum on improving bank cultures in 2014, said 'In addition to a strong compliance function, firms need to foster an environment that rewards the free exchange of ideas and views'.[12] The danger of the focus on senior management accountability is that managers continue to put up the 'accountability firewalls' described by the UK's Parliamentary Commission on Banking Standards (PCBS) in 2013:

> 'One of the most dismal features of the banking industry … was the striking limitation on the sense of personal responsibility and accountability of the leaders … for the widespread failings and abuses … Those who should have been exercising supervisory or leadership roles benefited from an accountability firewall between themselves and individual misconduct … Senior executives were aware that they would not be punished for what they could not see and promptly donned the blindfolds.'[13]

Andrew Bailey, new CEO of the FCA, said in November 2015, 'A firm's culture should promote discussion, debate and honest challenge. The alarm bells ring for us when we are told that the CEO or other Senior Executives are very sensitive to challenge'.[14] By requiring formal Statements of Responsibility to drive accountability, however, it is possible that managers will be driven to continue to don the 'blindfolds' and work to their strict responsibilities. Organisations should encourage, reward and demonstrate management curiosity — the interest in and concern for how the entire organisation is performing and risks to customer outcomes.

In addition to a focus on policy, controls and accountability, leaders and managers should be educated in making fast, complex decisions with many 'right versus right' repercussions, as well as unforeseen consequences. Since the 1990s, there has been a steady decline in management and leadership education in financial services. Historically, managers were sent on extensive education programmes, learning the skills of leadership and management on a regular basis. Now, the priority is 'just-in-time' training, linked to specific initiatives: a one-day workshop on a new product; e-learning for a new system that is being launched; re-training when things have gone wrong with sales or customer services. Firms should be dramatically increasing their spending on management education, and regulators and risk managers should be ensuring that this happens. This does not just mean knowledge-based training with multi-choice tests to 'demonstrate competence'. Rather, education should focus on the complexities of decision making, using case studies and business simulations of the daily strategic and operational decisions that leaders make.

UK financial services leaders and managers are seriously under-educated in decision making, leadership and risk management. Instead of a continued professional development (CPD) requirement of perhaps five days training or self-learning per year, most managers should spend at least one month a year away from their job being educated in decision making. Financial services is high risk and, like other high-risk sectors (the airlines, the armed forces), continuous time spent simulating likely scenarios and on education is required.

In most institutions, the recent launch of the new FCA Senior Manager and Certification regimes has been largely focused on operational implementation: responsibilities and governance mapping, creating and signing off 'Statements of Responsibilities', registering senior managers with the regulator, building systems to track allocated responsibilities and managers as they change have all been operational challenges. Training has largely been limited to short sessions informing managers about the requirements of the new regimes. In the embedding period, firms must turn their mind to extensive risk and leadership education programmes, or the aims of significantly improving management and decision making will not be met.

A culture of stress testing, scenario thinking and 'futurology'

Since 2008, regulators and governments worldwide have asked banks and systemic insurers to stress-test financial strength and to play out disaster scenarios. These have revealed weaknesses in some institutions and a need across the financial sector to increase capital and liquidity ratios significantly compared to pre-crisis levels.

Stress testing, scenario thinking and 'future-gaming' should become embedded in culture and common practice at all levels of financial organisations. Driven by continual external and internal regulatory and commercial pressures over recent decades, leaders' focus has been on managing the here and now. The challenges of remaining competitive, cutting costs and meeting shareholder expectations have led to '24-hour working' for most managers at all levels. Rarely are managers able to step back and think about the future.

Scenario planning and assessing future risks should be a core expectation of all managers, and the presence and quality of these activities should be included in risk and compliance reviews and audits at all levels, including external audits and regulatory supervision. Not only do these help predict and prevent catastrophes overtaking the firm and its customers, they also strengthen management and leadership capability. Armed forces spend the majority of their time gaming scenarios, not just because they prepare officers for the situations they will encounter, but also because they develop flexible thinking and the ability to respond quickly and effectively to unforeseen scenarios. These activities also reveal cultural blind-spots and blinkered thinking before they become critical. Peter Schwartz writes about the positive impact on leaders of involvement in scenario planning:

> 'Thinking through [scenario] stories, and talking in depth about their implications, brings each person's unspoken assumptions about the future to the surface. Scenarios are thus the most powerful vehicles I know for challenging our "mental models" about the world and lifting the "blinders" that limit our creativity and resourcefulness.'[15]

Moya Mason writes about the positive impact on leaders of involvement in scenario planning:

> 'Flexibility of perspective is also critical because a scenario planner must simultaneously focus on questions that matter to him/herself and also keep awareness open for the unexpected. Since most of us have built up a set of rigid filters, we pay attention only to what we think we need to know. To do a good job, therefore, one must become aware of where the filter lies and be able to continually readjust it to let in more data about the world.'[16]

A culture of future-thinking, together with the management and leadership practices that accompany this, should be a key characteristic of the culture of the financial services institution and should be highlighted and assessed at all levels by regulators and risk departments.

The learning organisation and 'double loop learning'[17]

As well as 'future thinking', a culture of learning from experience, particularly failures, characterises successful organisations. As Amin Rajan's research showed, a pattern of repeating causes have driven many enforcement actions by the UK regulators.

If the sanctioned institutions had been able to successfully learn from their errors, they could have avoided further breaches and the expense and management distraction that accompany them. The organisation that can build a culture of learning in this way can significantly increase earnings by avoiding the costs of fines, remediation and compensation.

Argyris[18] and Senge[19] developed the concept of the 'Learning Organisation', the organisation that can review its experiences (mistakes as well as successes) and continuously improve as a result. Argyris developed the concept of 'double-loop learning' to identify organisations and individuals who can both learn from experience (the first loop) and then review how well they and their organisation is able to do this (the 'double loop').

The role of the risk department is to be the champion of 'double loop learning'. Not only do they have expertise and a clear mandate to ensure that the institution understands what has failed and how to remediate and address the failings, they also have a mandate to assess how well senior managers learn the lessons from failures to build and improve controls, governance, culture and behaviour.

IMPLICATIONS FOR THE RISK MANAGEMENT FUNCTION

Assessing appropriate culture and behaviour requires risk management functions and specialists with a very different skillset, experience and intuition. Most functions are built around a rationalist 'assess, improve, audit' model. This is not appropriate for understanding and developing the more nuanced and intangible reality of organisational culture. We need a function and individuals that are given the mandate by regulators and shareholders to ask more challenging questions of the organisation. In his 'Smart and dumb questions to ask about risk management',[20] Michael Power proposes that assessing culture, governance and senior management practices requires new approaches on the part of risk professionals. He postulates that many of the questions asked of senior managers need to become 'smarter' and more inquiring, comparing this with his view of the 'dumb' questions that are often asked at the moment.

> 'Dumb questions simply invite busy executives to rehearse risk management clichés … An example of a dumb question could be "Do you have an embedded risk management system" or "Do you have a strong risk culture?"… Because dumb questions adopt the language and categories of existing abstract principles, they are also more likely to default into discussions about compliance, structure, and documents. Questioners may learn a lot about how risk management is structured and organised, but little about risk and how the business thinks about and deals with it.'

Power proposes 'smarter' questions that explore culture and leadership in practice and illicit an understanding of the nuances and grey areas in which most risk is hidden:

> 'Is the organisation good at stopping bad projects that have gained momentum?' 'When was the last time something was stopped because it was considered too risky?' 'How do you and your team avoid being dragged into doing the work of the business?'
>
> 'There is no mystery about smart questions … The real mystery is that so many countries have developed a public narrative of risk management that inhibits and crowds out this kind of intelligent risk oversight, providing overseers with a battery of banal questions whose answers leave one no wiser.'

So assessing risk in these complex and nuanced areas requires risk professions to develop new language and skills to be able to explore the reality of what is happening in their organisation day to day. Culture and management behaviour are not steady-state permanent characteristics that can be assessed in intermittent audits. They change on a monthly basis as the organisation faces different challenges and leaders make decisions to steer the boat through increasingly turbulent waters.

Just as leaders' education in risk management education should be upgraded significantly, so the development of risk professionals needs to build understanding and skills around the less scientific and rational aspects of why organisations

perform as they do. In a 2003 survey carried out by Enterprise Learning, we found that only 17 per cent of risk and compliance professionals were degree educated; 64 per cent disagreed that they experienced adequate professional development and 91 per cent said there was not adequate support for the development of risk professionals by their HR and training departments. Risk professionals, like senior managers, should be investing a significant amount of their time in education, building their understanding of their business, its culture and management practice, as well as the skills to assess these accurately and provide challenge and advice to management.

CONCLUSION

The emerging risk management and regulatory focus on culture, conduct and senior management behaviour is opening up complex and relatively unexplored drivers of organisational failure. They are correctly being attributed as major causes of the financial crisis, either directly driving dysfunctional behaviour or placing the organisation in a position where it could not respond quickly or effectively to the meltdown around it.

However, the current paradigms of risk management when assessing these critical aspects of organisational effectiveness are flawed. All of the current approaches are underpinned by the historic risk management and regulatory characteristics of pseudo-scientific and rationalist investigation. Audits, incentives, statements of responsibilities and 3LD models are only part of the answer, and however effectively these are being done, financial institutions are still suffering serious failures, leading to fines, customer detriment and organisational chaos.

Leaders, managers and risk professionals need to spend much more time being educated to understand the complexities of culture and behaviour. They should work together to ensure that their institutions become better at looking forward (scenarios, modelling and stress tests) and looking backward (critical incident reviews, 'double-loop learning') and build a culture that is able to strengthen the organisation and protect their customers and markets.

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