CARRRESEARCH

RISK CULTURE IN FINANCIAL ORGANISATIONS

R&R presents the executive summary of **Michael Power**, **Simon Ashby** and **Tommaso Palermo's** report on a new managerial challenge facing CROs, CEOs and Boards.

It is widely agreed that failures of culture, which permitted excessive and uncontrolled risk-taking and a loss of focus on end clients, was at the heart of the financial crisis. Many official reports, analyses, commentaries and blogs go further to focus on the cultural dimensions of risk-taking and control in financial organisations, arguing that, for all the many formal frameworks and technical modelling expertise of modern financial risk management, there was an lack of understanding of the social dynamics of risk-taking within financial organisations, including a failure to fully appreciate the motivations and ethics of decision-makers.

From this point of view, we regard the explosion of interest in risk culture in financial organisations since 2008 as being symptomatic of a desire to reconnect risk-taking, and related management and governance processes, to a new moral narrative of organisational purpose.

The primary aim of our research, extending over 18 months and involving several banks and insurers in the United Kingdom, was to discover and analyse how the risk culture change agenda was taking shape inside different organisations. From this grounded and bottom-up point of view we decided not to define risk culture in advance but to observe and understand its manifestations within organisations. We interacted mainly, though not exclusively with personnel from the risk function. While this may be seen as limiting the generalisability of our results, it was clear to us at an early stage that risk culture change programmes were being led by risk functions and that the reshaping of the organisational footprint of risk management was at the centre of these programmes. We supplemented this approach with a formal survey of CII and CIMA members and also engaged, for comparative purposes, with personnel from two non-financial companies – an airline and a large industrial company.

Our desk research of academic and practitioner literature on risk management, management control, culture and safety issues suggested strongly that risk culture is a way of framing issues of risk and culture in organisations, and not a separate object. In addition, risk culture is itself a composite of a number of interrelated factors involving many trade-offs. We approached the research with a number of additional prior assumptions:

- Risk culture is not a static thing but a continuous process, or processes, which repeats and renews itself, but may be subject to shocks.
- Risk culture will be a mixture of formal and informal processes. The former are easy to observe; the latter are harder to observe since they involve a myriad of small behaviours and habits which in aggregate constitute the state of risk culture at any one point in time.
- We do not assume that an organisation necessarily has a single risk culture and we accept that risk cultures may be trans-organisational. Conceptually we would prefer to speak of "risk cultures" which may be unevenly distributed within organisations (eg, retail as compared with investment banking) or across the financial industry as a whole (eg, insurers as compared with banks).

The most fundamental issue at stake in the risk culture debate is an organisation's self-awareness of its balance between risk-taking and control. It is clear that many organisational actors prior to the financial crisis were either unaware of, or indifferent to, the actual trade-off or risk profile of the organisation as a whole. A combination of control functions being ignored or fragmented, and of revenue generating functions being given star status, rendered the actual trade-offs involved in this balance institutionally invisible, both internally and externally, until disaster struck.

For this reason, the prescriptions arising from our research essentially point towards recovering the organisational capability to make visible, as well as to understand and accept or change, the actual control-risk trade-off. Many practitioners now articulate this in terms of organisational clarity about the nature and enforcement of risk appetite and we observe that this plays a large part in many risk culture reform agendas.

Our research reveals that, underlying this fundamental question of balance, our participant organisations were also grappling with several other significant trade-offs as they sought to address risk culture. Unlike a number of consulting frameworks, we do not regard one side of these trade-offs as necessarily "healthier" than another. Rather they provide a conceptual framework, arising out of our data, which allows us to describe the variety of approaches by our participant organisations.

These trade-offs also provide a way of framing some challenges that CROs, CEOs and Boards need to consider.

The swing back to the centralisation of risk management

Our research suggests that the risk culture debate is symptomatic of a desire to make risk and risk management a more prominent feature of organisational decision-making and governance. The pendulum has swung towards an increase in the centralisation of risk management within financial organisations. This is understandable given the events of 2007-9. We observe three interrelated dimensions of this shift.

- Greater structural formalisation of a "three lines of defence" model
- The creation of new risk oversight units and capabilities
- Increased attention to risk information consolidation and aggregation

Underlying this general change in the regulatory and organisational climate are a number of specific trade-offs which define and are fundamental to the way organisations think about and seek to act upon their risk cultures. We have documented the variety of ways in which organisations have consciously and unconsciously addressed these six trade-offs, often mixing approaches. We outline some key challenges for CROs, CEOs and Boards arising from these trade-offs.

Business partner or independent advisor?

The authority of the risk function is a core attribute of risk culture. We observe two approaches to increasing the footprint of risk within organisations. Partnership builders sought to engage directly with the business, seeking to position themselves as trusted advisors. Partnering overseers looked to influence the business via risk training programmes and general awareness-raising activities. The former approach involves acting on the capabilities of the risk function and developing greater business fluency and credibility. The latter involves acting on the capabilities of the business itself. Both approaches, which are often mixed together, confront "Three Lines of Defence" (TLD) frameworks which value and promote the independence of the second line risk function. Managing this trade-off between business partnering and structural independence is one among several key challenges.

Risk culture challenges for CROs, CEOs and Boards

- How would you monitor changes in the internal authority of the risk function? If you don't want to do this, why?
- Is the current balance between informal relationship building and formal training of the business in risk understood and consciously chosen? Does the risk function have a role in the design and implementation of risk training programmes?
- Are you recruiting and training risk managers in the different languages of the business or is there still an underlying mono-culture within the risk function? In the latter case, have you ever discussed your perception of such culture with colleagues in the risk function?
- Do you generate stories of risk management success and value creation and ensure that they circulate within the organisation and with regulators? Considering the last year, how many of these success stories can you recall?

Informal network building or formal processes?

Regular interaction and "touch points" between risk functions and the business are widely agreed to be important, not only in financial services. We observed interaction enthusiasts and realists. The former are wary of formal tools on their own, and invest time and resources in building informal internal networks. Realists suggest that too much interaction can inhibit decision-making; they also support the role of technology in mediating interaction – as did our comparator airline. Realists have more respect for TLD models than enthusiasts who continually work across first and second lines. Despite accepting its salience, none of our participant organisations tried to measure risk-business interaction and there seemed to be little ambition to do so.

Risk culture challenges for CROs, CEOs and Boards

- Can you name one or two individuals doing risk culture relevant work in your organisation? If yes, where are they (eg, risk, audit, business)? How often have you talked to them? And do you feel you give them enough support?
- Would you be interested to know whether and how interaction between your risk function and the business is changing? If so, how could you find this out?
- Do you track how many times business functions approach Risk for advice and partnering? If not, why not?
- If you have implemented a TLD approach in your organisation, do you think this has made interaction between the business and Risk more or less likely?
- Are you worried about a lack of interaction between Risk and the business? If yes, why? Can you think of concrete examples of situations where more interaction would have helped to address business problems? Or examples where too much interaction has slowed decision-making?
- Do you consciously translate risk appetite issues into a language which business units can understand and own?

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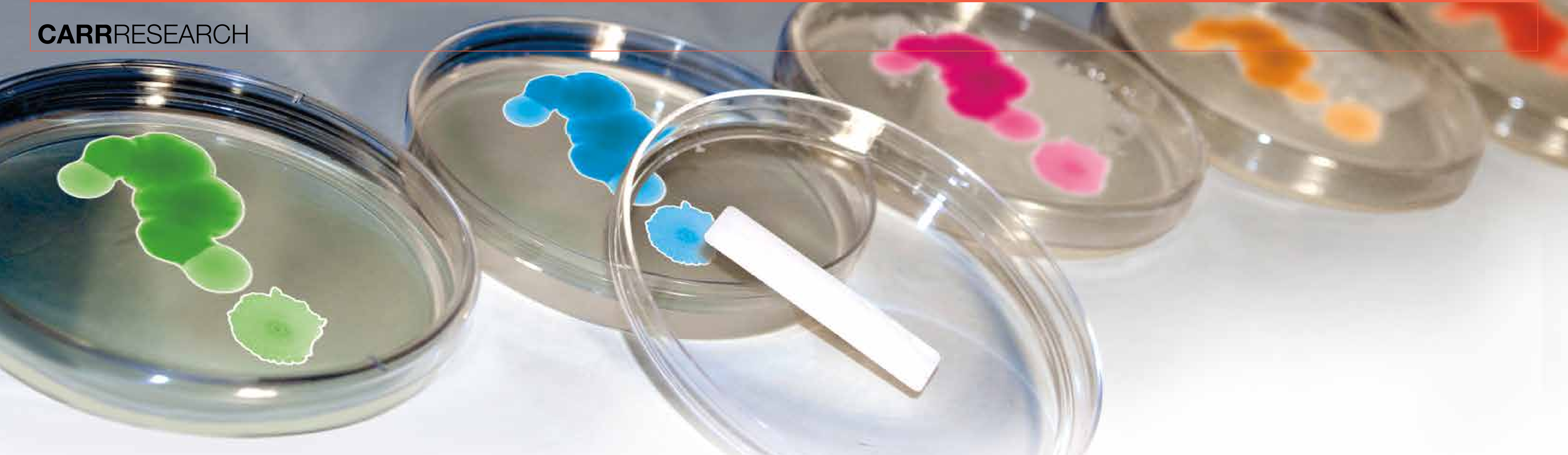

Between risk and control?

We observed that the clarity and enforcement of trading limits was regarded as a core feature of risk culture across all our participant organisations. However, we detected subtle differences in approach and attitude to limits. "Sandbox guardians" (a phrase we heard during our research) position limits as a means to an end and have a business decision facing approach to the enforcement of limits. In contrast, for what we call "gold-platers" (another term we heard used frequently), limits and related risk management policies and rules unintentionally become a system in their own right. Specific organisational inclinations one way or another were strongly influenced by their own histories and collective memories of bad practice. From the comparator airline, it also became apparent that the propensity to invest in knowledge of risk is a risk appetite and risk culture issue.

Risk culture challenges for CROs, CEOs and Boards

- How do you get assurance that the risk function is focused primarily on supporting business decisions?
- Do you know which areas of the business are "gold-plated" in terms of risk management and control? If not, how will you find this out and what will you do about it?
- When risk limits and tolerances are changed, is the risk function a leader or a follower in this decision?
- Do you understand the appetite for acquiring risk knowledge in your organisation?
- Have you ever discussed internally the implications for risk-taking and/or for your desired level of risk appetite of acquisition strategies, in particular if you plan to buy entire teams from other organisations?

Internal change or the use of advisors?

Under pressure to engage in some kind of risk culture change programme, many organisations have had to make decisions about whether to use advisors or not. We discerned a difference between consulting sceptics and enthusiasts. The former had a mixed set of attitudes: a recognition that change processes must be owned internally to be effective over time; scepticism about formal survey instruments in the market; and a feeling that advisors were primarily selling regulatory compliance. Enthusiasts were also mixed: some were driven by regulation, others sought leverage to develop new performance management systems with a risk component. And advisors themselves found risk culture a problematic consulting object. They were generally dissatisfied with existing approaches and recognised the need for a mix of skills. They were also searching for new ways to advise on decision-making processes.

Risk culture challenges for CROs, CEOs and Boards

- Does your organisation essentially have respect for advisors? Are you open to advisory propositions? How often have you been contacted by advisors in relation to risk culture in the last three months? And how often have you found their proposals of any interest or novel?
- Do you have processes to discuss the kind of expertise you may need, internally and externally, to progress risk culture change? Do you have an appetite for benchmarking with external entities? If yes, what have you done about it?
- Have you ever approached the topic of risk culture in meetings attended by people from both HR and Risk? If you are a member of Risk, do you have access to raw data from internal staff morale surveys? Or customer satisfaction surveys?
- Is your organisation open to exchanges with research organisations like universities? If not, are you sure of the reasons? If so, when was the last time there was such an exchange?

Own risk culture or regulatory culture?

Regulation has undoubtedly been a big driver of risk culture change programmes. Risk culture features in many regulatory speeches. We found that attitudes to regulation were mixed. Frustrated organisations talked about excessive documentary demands, how regulation was interfering with business decisions, and how it was crowding out attention to the softer dimensions of risk culture. Co-operatively disposed organisations accepted the new regulatory climate and sought to work with this more actively. A key issue is whether financial organisations understand the extent of the regulatory footprint on their business. The trade-off between their own approach to risk culture and that of the regulator is not even visible to many organisations. It also became apparent to us that there is a regulatory sub-culture in the sense of a network spanning parts of regulators, parts of financial organisations and parts of advisors who share common values. This network needs more research into its characteristics.

Risk culture challenges for CROs, CEOs and Boards

- Does your organisation genuinely respect the public objectives of the regulatory function? Do you have positive "regulation conversations" internally? How often? Who is participating in such conversation (eg, business, risk, compliance; senior or junior members of staff)?
- Do you push back and challenge the regulator? If not, do you know why not?
- If you think regulatory demands for documentary evidence are excessive, do you have a clear conception of what you would require in the absence of regulation?
- Do you have ways of tracking the extent to which regulation is "inside" your organisation? Do you have any processes to track the impact of regulation on work habits and internal attitudes to risk? Would you like to know?
- Do you know how compliance experts are regarded in your organisation? If so, do you want to change that? If not, do you want to know?

Levers on behaviour: ethics or incentives?

Behaviour modification is another key issue for risk culture change programmes. We noted two generically different approaches to behavioural risk. The first we call ethics or mission-based. It involves renewed corporate narratives for focusing on clients and respect for internal control processes. Interestingly, risk management is being re-positioned as a carrier of organisational ethics. In contrast, organisations also invest in disciplinary and incentives-based levers with greater short term purchase over behaviour in the form of risk metrics within the performance management system.

Risk culture challenges for CROs, CEOs and Boards

- Do you understand where in the organisation behavioural change is most necessary? If not, how will you get it?
- Which combination of levers is most likely to be effective in bringing about that change? Is such combination different in different parts of the organisation (eg, functional areas or hierarchical levels)?
- How are you monitoring and measuring "respect" for internal control and risk management?

Conclusions

Despite the apparent cynicism of the general public, our research demonstrates that financial services firms are engaged in extensive programmes of internal reform with a view to changing their culture of risk-taking and control.

The different trade-offs which emerge from our data are not mutually exclusive. Issues about the authority of risk expertise; the extent of interaction between risk and the business; the clarity of risk appetite; the use of advisors; the commitment to ethical change; and whether regulation casts a more significant shadow over risk culture than is commonly acknowledged are all connected. At the same time organisations implicitly choose a balance between longer term, organic processes of cultural change and shorter term, more engineered and visible levers over behaviour. Our report also suggests that the TLD model, which has been promoted as a solution to the financial crisis, should be looked at more carefully and critically for its side-effects.

Any research report is limited in time and space, by its methods and by data availability. It is part of the culture of financial organisations that they are not naturally open to external researchers and we have been unusually fortunate in our participant organisations for the access they have afforded us, for their trust in our processes, and for their candour in interacting with us. This report is very much by them for the public good.

We hope that our study will provide additional awareness of the complex challenges facing CROs, CEOs and Boards who genuinely wish to influence the cultural conditions under which risk-taking and control activity happens in their organisations. Our principal prescription is that there is a need for financial organisations to be aware of the many trade-offs we have identified – including what kind of relationship to have with the regulator – to monitor them, and to make explicit decisions about them where possible, rather than allowing them simply to happen to the organisation. When it comes to risk culture, our report suggests that it is not only the level of risk-taking which was deviant in many organisations. It was also the lack of this organisational self-knowledge and the authority to act upon it.

We have provided a number of questions arising from our work as a pathway to this awareness. But we have not sought to position our work as another advisory offering. The fact that the questions we pose are not easy to answer in a familiar practical way does not mean that they are not important. Indeed, we think they require the closest consideration.

The full report of Risk Culture in Financial Organisations is available here: www.lse.ac.uk/researchAndExpertise/units/CARR/pdf/Final-Risk-Culture-Report.pdf

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