PRESS RELEASE

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LSE and Plymouth University researchers challenge assumptions on financial scandals

Joint research from London School of Economics (LSE) and Plymouth University published today (Monday) dispels 'myths' that poor or deviant risk culture in financial institutions was mainly responsible for recent scandals.

The report, *Risk Culture in Financial Organisations*, says that current debates misleadingly equate risk culture with greater precaution and risk aversion. It challenges the notion that there is a clear distinction between 'strong' and 'weak' risk cultures.

One of the report authors, Professor Mike Power, an academic expert in risk management from the LSE, comments, "The risk cultures of financial organisations are full of trade-offs, and how they manage those trade-offs is fundamental. This clearly includes, but is not restricted to, the need to balance risk and return. In addition, we find that 'good' risk culture is as much about organisational clarity and confidence in making these trade-offs, as it is about the level of risk taken as such, or indeed about ethics."

The report also questions the direction of certain financial sector reforms, including the significant focus on issues such as governance, ethics and incentives.

Professor Power led the 18-month project in association with Dr Simon Ashby from Plymouth University, who is also a former financial regulator and risk management practitioner, and Dr Tommaso Palermo from the LSE.

Lighthill Risk Network is one of the consortium of private bodies funding the work. The other members of the consortium are the Chartered Institute of Management

Accountants and the Chartered Insurance Institute in association with the Government funded Economic and Social Science Research Council (ESRC).

Lighthill Risk Network director Dickie Whitaker says, “Reports on the financial crisis, such as the work of the Parliamentary Commission on Banking Standards, as well as numerous investigations into more recent scandals including LIBOR fixing and the London Whale, all highlight the significance of deviant risk cultures which have permitted unethical and destructive behaviours.

“However, to date, despite this great interest, there remains a significant lack of clarity about what the concept of risk culture actually means and therefore about how financial organisations should go about ‘strengthening’ their risk cultures. The report provides a unique perspective on the concept of risk culture and fills a key gap between academic research and industry practice.”

The team’s aim was to work with senior risk managers from a number of financial organisations to effect knowledge exchange, providing insights to improve their ability to understand and potentially manage their risk cultures.

It looked to reinforce its practical experience in risk management, and contacts from the financial services sector, with a robust academic approach to investigating the risk cultures of financial organisations.

Challenge to sector reforms

The report also challenges the direction of certain financial sector reforms, including the significant focus on issues such as governance, ethics and incentives. For example, the report highlights some key issues with the “three lines of defence approach” that is increasingly popular within financial institutions, where the staff within central risk functions are kept at arms-length from business level decision making.

Dr Simon Ashby comments, “The three lines of defence approach has a fatal flaw – while it may prevent risk staff from getting too involved in business level decisions and thus ‘going native’, it can also drive a wedge between risk staff and business management – leading to mistrust and mis-reporting.

“Often it is better to blur the first and second lines as this can improve interaction between staff. In the end risk culture is as much about creating a climate of trust and communication as it is about lines of demarcation”.

The report is published by the Financial Services Knowledge Transfer Network and is available at http://www.lse.ac.uk/researchAndExpertise/units/CARR/home.aspx

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- The Chartered Insurance Institute (CII)
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- The Lighthill Risk Network

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2. Author biographies

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Simon Ashby is Associate Professor in Financial Services at the Plymouth Business School Prior to this he worked as a financial regulator (at the UK Financial Services Authority), and was a practicing risk manager in a number of large and small banks. Simon has a PhD in corporate risk management and has published many academic papers in respected journals (e.g. British Journal of Industrial Relations, Geneva Papers, Safety Science, Risk, Decision and Policy), book chapters, professional articles and industry reports in the fields of risk management and financial services. Simon remains actively involved in the financial services sector and is a Fellow and the Chairman of the Institute of Operational Risk. Email: simon.ashby@plymouth.ac.uk

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