The new buzzword in the financial services industry is culture. Every week, it seems like a regulator raises culture as a major challenge facing the industry. Although the issue has been simmering globally for several years, LIBOR and foreign-exchange manipulation pushed it way up the regulatory agenda. As Financial Stability Board Chair Mark Carney put it, “The succession of scandals means it is simply untenable now to argue that the problem is one of a few bad apples. The issue is with the barrels in which they are stored.”

As a result, misconduct is now viewed to be a global systemic issue, and one about which financial and systemic regulators are deeply concerned. (See “What is conduct risk?”)

Given that many firms have been working on cultural issues over the past year or so, their leadership generally is struggling with how to react. Some leaders bristle at the barrel analogy and the implication that they have to refute it. Many firms believe that the bad apples have been identified, and to the extent that some remain, it’s emblematic of a subculture, not of the firm or industry as a whole. Yet saying one’s culture is strong, and behavior is appropriate, is one thing; evidencing it is entirely different.

Risk Governance 2020

EY believes financial services firms face a sea change in how they approach risk governance. Risk culture is one component of this overall effort.

The transformation required will take a comprehensive, multi-year effort to substantively complete. To remain at the forefront of today’s market, firms should adopt an integrated approach that capitalizes on the value gained from upgrading risk governance: placing an equal focus on financial and nonfinancial risks in the short and long term, embedding evolving regulatory and supervisory expectations, and delivering tangible results in a cost effective manner. We call it Risk Governance 2020: a shift from satisfactory to effective and sustainable.
Start with the behaviors you want

The natural instinct in most firms is to think about what metrics can be used to show their culture is strong. A second reflex is to draft a long employee survey on culture or to add questions to the annual employee engagement survey. Let’s take the pulse, executives say. These instincts presuppose that firms know what risk behaviors they want to have employees exhibit. Yet, as Sarah Dahlgren, Head of Supervision of the Federal Reserve Bank of New York, put it, “Employees should know what behaviors are expected from them and how their actions will be measured.”

Few organizations have written down the behaviors that they believe are important from a risk culture perspective. They can point to their corporate value statement, which typically highlights the need to put the customer first, or to their codes of conduct, which emphasize ethics and compliance. But as Securities and Exchange Commission Chair Mary Jo White said recently, “We are not talking here about a ‘check the box’ compliance program or nice-sounding codes of conduct.” Indeed, written codes and value statements reflect aspirational culture rather than actual behaviors, and reliance on them in the absence of empirical validation can perpetuate cultural weaknesses.

Instead, senior management has to align those essential behaviors with the firm’s agreed-upon strategy to enable and encourage the necessary risk profile and risk tolerance. This is no mean feat. Management has to debate and confirm the agreed-upon behaviors. The list of behaviors should be limited to the six to eight most critical. For each one, several more specific behavioral indicators have to be agreed upon to assess whether the desired behaviors are being followed in practice. This is an iterative process, and necessarily so. It cannot be just words on paper; there has to be an agreement on what those words mean and why they are important. EY has identified critical risk behaviors, including being responsible and accountable for one’s own actions, collaborative, ethical and compliant, communicative, and stakeholder-oriented.

Desired behaviors have to be agreed to at all levels of the organization and across all businesses and regions. Too often, frontline employees do not see the day-to-day relevancy in high-level principles. Sometimes behaviors outlined by head office are viewed as “not how we do business in this country.”

A good starting point for any organization is to consider what could really affect its reputation and standing and then make sure that the responsibilities and the desired behaviors are clearly set out in the organization at all levels to maintain the firm’s reputation. The mechanisms to influence behavior such as the incentive and recognition schemes, risk appetite, risk governance and risk transparency all need to be considered, as do performance targets, which also drive behavior.

---

What is conduct risk?

The term “conduct risk” comprises a wide variety of activities and types of behavior that fall outside the other main categories of risk, such as market, credit, liquidity and operational risk. In essence it refers to risks attached to the way in which a firm, and its staff, behave in a wide range of market-facing and internal situations. Although there is no official definition, conduct risk is generally agreed to incorporate matters such as how customers are treated, remuneration of staff and how firms deal with conflicts of interest.

The public discourse on financial services culture has been vague, to say the least. Misconduct and poor culture have become synonymous. Indeed, regulators have been pressed to be more specific. The Wall Street Journal recently reported that, despite now speaking routinely about “culture,” William Dudley, President of the Federal Reserve Bank of New York, said, “I think culture is too broad a way to describe this. I think, reflecting on it, it’s really about ethics and conduct.”

Still, misunderstandings prevail.

A common language is required. Conduct is a broad concept that captures a range of issues. Employees’ deep ethical biases influence firm cultures, and that is the context in which the mindset and approach toward compliance exist. Within that, there is a subset of activities or factors that create what regulators or supervisors view as conduct risks. These are often called market conduct (or market integrity), consumer protection, and wholesale and corporate market conduct issues, and in many cases, they overlap. To align with regulatory or supervisory thinking, a firm’s conduct risk approach has to address these issues individually and systematically.

---

We talk the talk, but do we walk the walk?

So, once the desired behaviors are agreed to, the next step is to determine whether those behaviors exist in practice.

Firms often leap to conducting surveys. The allure of getting the firm-wide “answer” is strong, and annual employee surveys are commonplace.

In the context of risk culture, however, such surveys have limited value. Too often, employees race through these surveys, and many simply don’t believe answers will remain anonymous, statements to the contrary notwithstanding. Open-ended questions are passed over, if possible. Cultural or legal differences across countries can influence how people respond to survey questions — for example, some may not feel comfortable dissenting from their superiors, and some may prefer to use whistle-blowing mechanisms.

Despite their limitations, broad surveys can be useful. Surveys can identify outlier groups or cohorts within an organization. The benefit of broad-scale data is that it can be analyzed to identify where problem spots may exist. But surveys rarely identify what the problems are, their causes or how to address them. A deeper approach is necessary.

Structured interviews and focus groups are a much more powerful approach. By interviewing senior and middle management and facilitating dialogue among a well-sampled set of front-line employees, it is possible to determine gaps between desired and actual behaviors and why they exist.

If conducted professionally and independently, such an approach breaks through the limitations of broad surveys. So long as superiors or direct colleagues are not in the room, employees are often very keen to talk about culture and what drives it.

This makes it easier to see the causes and what needs to be changed to influence culture going forward. Participants can be asked not just whether they think the firm accords with a particular desired behavior, but also how they would rate the firm on a scale. This balances the qualitative and quantitative. By requiring participants to state their agreement or disagreement with statements about desired behaviors, a unique data set can be created that can be contrasted across geographies or units. By asking the “why” questions, root causes and potential remedies can be raised and discussed.

Skeptical firms point out that while such findings may be compelling, they are directional, not representative. The sample size of interviews or focus groups will always remain small, relative to a firm-wide survey. But that’s where the data come in.

Once patterns start to emerge, data can often corroborate such patterns or raise questions. To illustrate, assume front-line employees assert that, no matter what management says, big revenue producers get the highest bonuses or are promoted regardless of their behavior. Such an assertion can be tested. In the US, processes implemented as a result of guidance on incentive-based pay should identify instances where behavioral factors have negatively impacted individuals’ bonuses. Similarly, the human resources function should be able to evidence how values have been taken into account in senior promotions; if they can’t, it would not necessarily support the employee assertion, but it would prompt additional analysis. Other such examples exist.

Using data analytically becomes a powerful way to move findings from merely directional to truly representative. Interviews can unearth long-standing beliefs within the organization; data can be used to assess their validity.
Mind the gap

Even in the most well-managed firms, gaps exist between desired and actual behaviors. So firms have to determine how to close those gaps, as leaving them unaddressed could allow them to fester and increase conduct risk.

Some firms have designed and implemented a comprehensive risk culture program. Sometimes this is necessary, especially when serial, deep culture failings prevail. However, for most, it means leveraging existing programs and frameworks – not something new, but something borrowed.

To do this effectively means looking well beyond risk at issues that cut across functions risk, compliance, internal audit, human resources and include senior front-line management.

A broad framework is required to assess culture across the institution. That framework must ensure that the organization is communicating the right messages, taking the right risks, providing the right motivators and allowing everyone to pull in the same direction. (See the “A multifaceted set of mechanisms” sidebar on page 6.)
A multifaceted set of mechanisms

EY’s approach entails eight core mechanisms that relate to leadership, the organization, the risk framework and incentives:

**Tone at the top.** Every organization says its leadership values are strong. Senior management - and above it, the board - understands what’s important and routinely sends out the right messages. “Customers come first.” “Ethics and compliance matter.” However, the actions of firm leaders do not always follow their rhetoric, and, in any case, attitudes in the middle and at the bottom of the organization are often as important as the tone at the top. Do senior management messages get relayed and reinforced at all levels, or are they corrupted and distorted? Are sales targets set for the businesses driving the wrong behavior?

**Risk behavior standards.** Other than saying employees should do the right thing, has senior management explicitly identified, codified and communicated the risk behaviors that they want exhibited, at each job level? Do they and their middle-management colleagues actually model the desired behaviors?

**Roles and responsibilities.** Regulators are very clear that front-line business units must be held responsible for all risks attached to the area covered by their revenue responsibilities and that independent control functions should exist in the second line for all risks. This is leading to a change in the three-lines-of-defense model, requiring greater clarity of roles and responsibilities in the risk governance framework. Increasingly, regulators are forcing firms to assess whether they have the right people with the right competencies in those roles.

**Risk governance.** Once roles and responsibilities are clearly laid out, effective execution becomes key. The easier (though not easy) part here is formalizing how authority is delegated and how approvals are processed. The harder part is encouraging employees to escalate problems appropriately as they arise. This requires employees to speak out, and be free from adverse consequences for doing so, even in instances that end up being benign. Employee access to the board and senior management to raise concerns should be unfettered.

**Risk appetite.** The risk appetite framework must be robust, must be cascaded far down the organization and must factor in nonfinancial risks, such as conduct risk, appropriately. The question is whether risk appetite passes the “use” test: do individuals deep in the organization appreciate how the firm’s risk appetite enables and constrains their day-to-day activities? A successful framework makes clear what individuals are accountable for, in terms of the risk appetite for their area of business including nonfinancial risks.

**Risk transparency.** Information flows are critical. Without a true sense of what’s going on, it’s difficult to know whether risk is being identified, managed and mitigated effectively. A key issue is whether voluminous information and data get translated into intelligence that can be acted upon. Useful information requires quality, accessibility and utility, not quantity.

**Rewards.** Clearly, financial incentives are important, but a proper risk framework goes well beyond that. Rewards also include nonfinancial incentives that influence what gets done. For example, in one firm, IT programmers who finished their coding first got highest praise and assigned to cherished new projects. Speed was the feature that was rewarded. Yet speed often led to security flaws. Without a countervailing reward for security consciousness, speed won out.

**Employee life cycle.** Financial rewards are a primary motivator, of course. However, human resources professionals control an array of other processes that influence a firm’s culture. Does the recruitment process factor in cultural fit or just technical experience and competence? Does training effectively reinforce expected risk behaviors? Who is promoted cultural champions or revenue producers? Are whistle-blowers promoted or shunned? Do those who exhibit unacceptable risk behaviors get punished? How do individuals within a business unit react to bad behavior by others? Human resources is predominantly a first-line function that enables the firm to attract and retain necessary talent. But in the area of culture, it can play a quasi-second-line role given that it has some critical processes at its command that influence behaviors.
All change

Ultimately, achieving an appropriate risk culture is not about the diagnostic; the goal is identifying whatever organizational change is needed and making that happen. Gaps between desired and actual behaviors will exist, in isolated instances or more broadly. Even the best cultures have pockets or subcultures where change is required.

When firms embark on an explicit approach to culture, senior management has to be open to the findings and needs the resolve to stand behind the necessary change program, however large. To do any less would undermine the goodwill accrued through undertaking the effort.

Management has to recognize that changing a firm’s risk culture is a journey. It is important that firms use knowledge gained in the diagnostic phase to develop a dashboard of metrics that directionally help monitor culture, or at least its proxies, on an ongoing basis. Periodically, the firm should repeat its initial diagnostic approach to see how progress has been made against the baseline.

A structured approach to assessing culture, as outlined above, will highlight not just the gaps but the causes and will help identify what needs to be changed. In particular, how can the mechanisms set out above be strengthened to deliver the desired culture? This means effectively leveraging the raft of strategic, operational and risk management transformational projects already going on within the firm to reinforce culture. “Change champions” at every level need to be identified, preferably executives and employees who have influence over their colleagues. A comprehensive, ongoing communication and training strategy is critical.

Firms that start down this route will reap significant benefits. Some firms have accepted the challenge as a result of negative experiences. Others concede that risk culture has been put on the agenda because of regulators and supervisors. But it’s not helpful to view risk culture solely as yet another compliance exercise. Firms have to grasp this issue with a positive mindset. It certainly is about stamping out misbehaviors, but it is also about highlighting and reinforcing positive behaviors: doing the right thing, calling out problems, challenging decisions or proposals, accepting change. And most importantly, it is about preserving brand and value creation. Positive reinforcement can be the most effective way to embed desired behaviors.

Regulators and supervisors have put culture on the agenda due to what they perceive to be local, perhaps systemic, failings in ethics and conduct. A negative is always hard to disprove, particularly in the face of substantial evidence to the contrary. Firms are better advised to see this as an opportunity, one that could, over the coming years, help underpin a transformation in how firms are governed and controlled, ultimately at a lower cost.

EY’s *Risk Governance 2020*: a shift from satisfactory to effective and sustainable

---

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Ernst & Young LLP refers to the individual client-serving member firms of Ernst & Young Global Limited operating in the UK, US, Ernst & Young refers to the client-serving member firm of Ernst & Young Global Limited operating in Hong Kong. For more information about our organization, please visit ey.com.

EY is a leader in serving the global financial services marketplace

Nearly 43,000 EY financial services professionals around the world provide integrated assurance, tax, transaction and advisory services to our asset management, banking, capital markets and insurance clients. In the Americas, EY is the only public accounting organization with a separate business unit dedicated to the financial services marketplace. Created in 2000, the Americas Financial Services Office today includes more than 6,900 professionals at member firms in over 50 locations throughout the US, the Caribbean and Latin America. EY professionals in our financial services practices worldwide align with key global industry groups, including EY’s Global Wealth & Asset Management Center, Global Banking & Capital Markets Center, Global Insurance Center and Global Private Equity Center, which act as hubs for sharing industry-focused knowledge on current and emerging trends and regulations in order to help our clients address key issues. Our practitioners span many disciplines and provide a well-rounded understanding of business issues and challenges, as well as integrated services to our clients. With a global presence and industry-focused advice, EY’s financial services professionals provide high-quality assurance, tax, transaction and advisory services, including operations, process improvement, risk and technology, to financial services companies worldwide.

© 2015 EYGM Limited.
All Rights Reserved.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com