Bank Governance Leadership Network
ViewPoints

May 29, 2014 TAPESTRY NETWORKS, INC · WWW.TAPESTRYNETWORKS.COM · +1 781 290 2270

Developing effective and sustainable risk cultures in banks

Since its inception in 2009, the Bank Governance Leadership Network (BGLN) has discussed the progress and challenges in improving risk governance in banks and the efforts of boards and supervisors to assess its effectiveness. Ultimately, the objective of this work is to embed risk management into all aspects of bank operations, i.e., to instill an appropriate risk culture throughout the organization.

Many of the challenges that continue to plague the banking industry have been cast as issues of culture. Recently, Christine Lagarde, managing director of the International Monetary Fund, asserted that little had changed: "While some changes in behaviour are taking place [in banking], these are not deep or broad enough. The industry still prizes short-term profit over long-term prudence, today's bonus over tomorrow's relationship."[1] In this context, banks have been considering some core questions about their purpose and objectives in order to address potential cultural issues. In answering these questions, *"bank boards should set very clear objectives and nourish the development of a strong culture,"* to ensure that they *"transform aspirations into practicalities through culture."* A core part of improving risk governance is the need to define risk objectives through risk appetite statements and to align the broader risk framework with the risk appetite. A persistent challenge has been to ensure that work on risk appetite is truly embedded in the businesses and that core risk objectives are understood and are driving behaviors at all levels.

Supervisors are increasingly focused on assessing risk culture in financial institutions as the ultimate test of whether improvements to risk management and governance processes have been effective. It is not just a "soft" issue: as one executive remarked, *"Risk culture is critical to what we do. It's probably our greatest safeguard as an organization."* And although one executive said, *"It's critical that [a strong risk culture] is embedded in the DNA of the firm,"* he went on to say, *"That's not going to happen overnight."*

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> – Executive

The BGLN has been actively discussing risk culture over the last year. During that time, Tapestry and EY have spoken with over 50 leaders in the banking and supervisory community [A list of participants engaged in this work is included in the Appendix], including a roundtable meeting in New York in March 2014. This *ViewPoints*[2] captures the essence of these discussions, and aims to provide context for executives, boards, and supervisors to think about instilling, monitoring, and sustaining effective risk cultures in banks. This *ViewPoints* includes a discussion of the following critical points:

- **Risk culture is an increasingly prominent part of supervisors' assessment of risk effectiveness**
- **Effective risk cultures share some key attributes**
- **Banks and supervisors are refining approaches to understanding and assessing cultural effectiveness**

Risk culture is an increasingly prominent part of supervisors' assessment of risk effectiveness

In BGLN conversations, many senior supervisors highlighted risk culture as among the top supervisory priorities in 2014. In many ways, the focus on risk culture isn't new, and to an extent, the approach *"looks like supervision did decades ago with its emphasis on people, not a model-based approach,"* as one supervisor remarked. Though risk culture has been an implicit part of supervision for decades, the financial crisis, followed by a series of prominent risk management and behavioral failures, have caused supervisors to increase their focus on the issue. As the Financial Stability Board (FSB) paper on assessing risk culture states, "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."[3] Significant incidents of risk failure despite investments in compliance, controls, and risk management have caused supervisors and banks alike to ask why these issues persist and whether the root cause might be cultural. It is clear that a focus on more rules or controls has limitations if effective risk management is not embedded in the culture. The FSB paper states:

> Supervisors should consider whether an institution's risk culture is appropriate for the scale, complexity, and nature of its business and based on sound, articulated values which are carefully managed by the leadership of the financial institution. In this regard, supervisors should set expectations for the board to oversee management's role in fostering and maintaining a sound risk culture.
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> This requires supervisors to effectively articulate these expectations to the board and senior management and ensure ongoing follow-up on whether these expectations are being met.[5]

Supervisors are refining their approaches to assessing risk culture and these are likely to vary

A senior supervisor said they hope to *"legitimize"* risk culture as a topic for explicit discussion with the institutions they supervise by providing a foundational approach for supervisory efforts to assess risk culture through the FSB Supervisory Intensity and Effectiveness Group. While this work will help to *"communicate ideas and bring everyone to the same place,"* in the words of one supervisor, a BGLN participant noted that it *"doesn't aim to harmonize supervision; national jurisdictions will take different approaches."* Indeed, as an EY analysis of the FSB report observed: "Timelines will differ, and supervisors will take a variety of approaches to meet FSB expectations … In some jurisdictions, supervisors will do specific reviews focusing on culture while others will embed their cultural assessments in their ongoing review work."[6]

A supervisor observed, *"We are in early days for how to supervise for risk culture – people inside the bank, who are part of the culture, can describe the culture; it is much harder to observe from the outside."* Some bank participants expressed concern that individual incidents would be treated as evidence of cultural problems. Some supervisors acknowledged that they have questions about when to intervene if they conclude that there is evidence

Defining risk culture

Much has been written and discussed about the need for culture change in banking. Risk culture is typically defined as a subset of the broader culture, which is of most interest to supervisors. The FSB says supervisors are focusing on "the institution's norms, attitudes and behaviours related to risk awareness, risk taking and risk management …"[4]

of a potential cultural problem. Then, how would firms demonstrate that the issue had been appropriately remediated?

Fundamentally, all supervisors are confronting the same major challenge: understanding the values that drive behaviors in an organization from an external perspective. Supervisors recognize that assessing *"the hardware"* of risk management and governance – the controls and processes in place – is much easier than assessing *"the software,"* the elements that truly help define culture. Therefore, the FSB's guidance on risk culture states, "An anticipatory and strategic approach to supervision rests, among other things, on the ability to engage in high-level sceptical conversations with the board and senior management on the financial institution's risk appetite framework, and whether the institution's risk culture supports adherence to the board-approved risk appetite."[7] As one supervisor said, *"[Supervisors] always have that challenge in assessing culture: if you make it too quantitative, you'll miss the boat [and] I don't know how you'd understand the culture without interacting with a wide variety of people."*

Though supervisors are generally moving in the same direction, it is clear that jurisdictions may take significantly different approaches. In part, this is because regulators have different mandates. At least one is experimenting with the use of behavioral psychologists to analyze risk culture, while others have emphasized the need to avoid creating a formal assessment process that risks becoming a bureaucratic compliance exercise. As supervisors more formally include an assessment of risk culture in their work, several agreed that they need to be careful not to create an overly formal approach to an issue like culture: one supervisor asserted, *"If there is anything to avoid, it is creating a rating process for risk culture."*

"If there is anything to avoid, it is creating a rating process for risk culture."
– Supervisor

Sound risk cultures share some key attributes

All firms have a risk culture, but defining what makes for an effective, sound risk culture is essential. A "strong risk culture," does not necessarily mean it is effective in leading to value-creating behaviors. Many financial institutions would have said they had a strong risk culture prior to not only the financial crisis, but also subsequent risk or control failures. It is therefore important to define the attributes of the desired risk culture and embed those in the organization.

Beyond tone from the top: the right values and risk objectives should be clearly articulated and reinforced by leadership actions

Having a strong "tone from the top" is often cited as an essential component in an effective culture. Embedding and encouraging an effective culture needs to start with clear and consistent definition and support from the board. A director stated, *"There is nothing soft about it from the board perspective. When something goes wrong, fix it and ask the questions, 'Do we need systems, people changes, etc.?' That culture being reinforced by the board is key."* It is then essential that senior management reinforce the core values that should drive the right risk behaviors. A participant observed, *"If you don't have the tone at the top set by the CEO with consistency, no matter what risk management says, people will just get around it."*

So, it is important first to get the rhetoric right: what are the strategic objectives of the firm? How do we take and manage risk? What behaviors are consistent with those objectives? What are our core values and standards? How will people be held accountable for living up to those values and standards?

Many BGLN participants say their firms have spent time and energy in recent years developing and refining mission and values statements, risk appetite statements, and firm strategies. Participants emphasize that culture cannot be defined, however, by the words perfected in mission and value statements enshrined in plaques, or from speeches from senior executives or board leaders. The work is in translating those things into a clear articulation of the expectations for behaviors that together form the basis of an effective risk culture. Generally, most would agree with some core attributes of a sound risk culture: that the culture should be objective about risk, be fully aware of the risks being taken, and understand the implications of those risks materializing. In addition, all employees take ownership for managing risk and line management takes responsibility for both risk and return, and ensures that risk is appropriately priced. Risk controls should complement these objectives by ensuring risk takers stay within their limits.

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– Director

Still, linking these objectives to specific behaviors and establishing those as norms remains challenging in large organizations. A director suggested that when we talk about changing culture, we are really talking about changing the *"behaviors of about 1,000 senior managers throughout the firm. If you can get them to change behavior, you change the culture of the firm."* That change in behavior demonstrates how core values are translated into actions, and those behaviors must be encouraged throughout the organization via multiple mechanisms. This requires consistency in messages from the top, to the middle, to the bottom of the organization – both through formal communication and training, but also in the range of ways – formal and informal – that appropriate behaviors are

FSB's foundational elements and indicators of a sound risk culture

The FSB report acknowledges that "risk cultures vary across institutions," but it outlines a core set of elements that financial institutions are expected to have in order to meet supervisory expectations:

- Effective risk governance
- An effective risk appetite framework
- Effective compensation practices aligning compensation with prudent risk taking

In addition, the FSB report outlines a set of indicators of a sound risk culture:

- Tone from the top setting core values and expectations and demonstrating behaviors that reflect those values
- Accountability for risk taking among relevant employees
- Effective communication and open challenge
- Incentives that reinforce the desired risk management behaviors[8]

encouraged and inappropriate behaviors discouraged.

The following elements form the basis of risk culture:

- **Risk culture needs to be rooted in the risk appetite.** The process of refining risk appetite statements has provided a useful basis for clearly defining strategic objectives, acceptable risk taking, and a core set of risk metrics and parameters specific to each institution. As a supervisor observed, *"The culture has to be consistent with the risk appetite. If the culture undermines it, people will find ways to circumvent limits, to find gaps in the risk appetite framework, and you will end up with risks that are not within the appetite."* Another participant said risk culture is about explaining, *"This is our strategy, this is why we take risk, and this is what happens when your behaviors don't align."*

- **Risk must be appropriately priced and performance objectives calibrated.** Performance objectives and returns should be properly risk adjusted and performance monitored, for capital to be effectively priced and allocated. Businesses must be charged commensurate with the risk involved for use of the balance sheet. If banks are setting high-return targets, a participant asked, *"How can they be so much higher than GDP growth in your core markets? You are not properly pricing risk, which basically means using excessive leverage. So, how does that link back in to risk appetite? We need to see that banks are grappling with things over the long term by taking proper actions to gradually get ROE above the cost of capital."* If performance targets don't match the tone at the top, excessive risk taking could be encouraged: *"A 'bad' culture is one where the CEO talks about the culture being open and transparent, risk-based, but there is pressure in the operating units to achieve revenue targets and they do whatever they have to in order to achieve them,"* according to a director. In some businesses, it is also important to set the right kind of performance metrics. One participant asserted, *"Revenue targets in retail will get you in trouble,"* by encouraging volume over quality.

- **Values need to be communicated as drivers of performance.** A participant stated, *"You cannot let people divert from the core point, which is that values drive value. Many institutions are still trading below book value. That is a profound statement about how investors view them. The market is saying, 'We don't believe you, we don't believe you can do anything in the future but destroy value.' We need to make this real."*

- **Core values need to be consistent across the enterprise.** While cultural and functional differences exist in the cultures of many large, global banks, the core set of institutional values should be consistent throughout an organization. Though one participant observed, *"There are national, geographical differences,"* another asserted, *"Banks have to run the ship in a tighter way with clearly defined global standards. Running parts of the business to local standards is too dangerous now."* Similarly, an executive said, *"There are sometimes pockets of a bank that have been aggressive and that became their values."* To have an effective risk culture, *"the basic principles can't be materially different across geographies or businesses. It should be achievable to have common principles across businesses, and if it is not, those businesses shouldn't be part of the same organization. Differences undermine what you are trying to do."*

- **Values need to be translated into desired behaviors.** Statements about values need to be made tangible. A participant said, *"You need to provide examples of the kinds of behaviors that are acceptable and unacceptable to avoid ambiguity."* Another uses different terminology for this reason: *"Culture is difficult to measure, difficult to make real. I prefer 'risk conduct.' It is easier to measure behaviors."*

> *"It should be achievable to have common principles across businesses, and if it is not, those businesses shouldn't be part of the same organization."*
> – Director

Accountability should be clear, and effective challenge encouraged

A focus on strengthening the risk function cannot contribute to a shift in accountability and ownership for risk. A participant said, *"Many people had outsourced risk in the organization [to the risk function or compliance] and we're trying to overturn that from a cultural perspective and reinforce that the business owns the risk and it's everyone's responsibility … Culturally they have to wear that armband every day."* The roles of the risk and control functions, and their stature and ability to challenge effectively, then become important checks and balances, but should also be integrated into decision-making processes, not serve as an after-the-fact check on business activities.

An integral part of creating organizational accountability is clear, consequential, and transparent action taken in response to behaviors that are contrary to a firm's desired risk culture. One executive, discussing the importance of real consequences for employees, said, *"On the accountability issue, as we come across issues, we are less forgiving than we had been. The view is that you have to make an example out of people to get the message across that you're serious about it."* Importantly, there must be balance in holding people to account while also encouraging the escalation of issues. Highlighting this concern, an executive said, *"You don't want a firm that is fearful, but you do want them to understand the consequences – that creates awareness. I am more concerned about [creating] a culture where transparency, the early identification of issues, and not hiding problems, is encouraged."*

Risk management and governance are embedded in decision-making at all levels

Changes to risk governance have extended well beyond the board room and central risk function. Part of an effective risk culture is ensuring those governance processes are embedded in all parts of the business and are part of any significant decisions. An effective risk culture includes effective governance processes, including new product approvals, but also ongoing reviews of products and modifications to avoid relaxing standards over time. To avoid that outcome, a director said, *"innovation needs to be well controlled, and you also need regular checkpoints."* Some banks have also adopted simple documentation requirements that require employees to explain how any decision fits with the risk appetite.

A practice adopted by some banks to better integrate risk governance processes into the businesses is rotating employees into non-frontline functions, notably risk, compliance, and internal audit. At the 2013 BGLN Bank Directors Summit, regulators "expressed support for greater mobility into and back out of risk and control functions, and some suggested those jobs should have improved compensation and career trajectories associated with them." One participant said, "Developing leaders and giving them risk management exposure is important … Instead, we have this tribe of people called 'risk specialists.'"[9] An executive suggested the risk and control functions need to be integrated into the business: *"You need communication around the business that happens naturally. Often, we have an exhausting amount of communication to ensure the business and control functions work together to get business done."*

All functions in the bank have a role to play in risk processes to ensure an effective risk culture. In particular, supportive functions for risk culture must include involvement of these functions:

- **Risk.** A key factor in risk culture is the relative status and caliber of the risk function in the bank, a focus at most institutions before, but certainly since, the financial crisis. One supervisor stated, *"Another important issue is how large is the influence of risk managers – are they taken seriously? Compensated fairly?"* In addition to being an important check on business risk taking, the risk function should be viewed as a risk enabler, a business enabler that helps businesses take and manage risk effectively.
- **Internal audit.** There has been growing consensus among supervisors that they will be increasingly scrutinizing internal audit for relative strength and stature, and one supervisor predicted a focus on internal audit would *"be the next shoe to drop,"* receiving similar focus as that which has been given to the risk function. Another supervisor said of internal audit responsibilities, *"The bar continues to rise and you could see it move more … We're at a bit of a crossroads with internal audit, there was a big shift 10 to 15 years ago [in responsibility], and I think we're at another one now."* Despite reservations from some participants that internal audit cannot adequately fulfill an expanding mandate, with one saying, *"There's a danger in having internal audit looking at things, like governance, that are not in their competency,"* it is increasingly clear that they will need to be equipped to do so.
- **Human resources.** HR's deep involvement in the employee experience, from hiring, training, and evaluating, requires that it work with the risk function to ensure that risk culture factors are integrated into its processes. Stressing the importance of including HR in risk culture, one executive commented, *"An important piece [of risk culture] is that it has to work with the HR function … if the HR function isn't picking it up, the risk culture by itself won't do anything."*
- **Finance.** The finance function can play a role in ensuring budget decisions are in alignment with a firm's risk culture and risk appetite. For example, risk budgeting and transfer pricing should be set commensurate with risk and businesses charged accordingly.

Values and associated behaviors are instilled, encouraged, and supported throughout the employee lifecycle

To ensure effective risk management is instilled and adopted by employees, key cultural values and risk principles need to be instilled and promoted consistently, from hiring through the end of employment:

- **Hiring.** As part of hiring recruiting strategies, one participant said bank leaders should consider, *"How is culture integrated? How are new employees assimilated into the culture?"*
- **Training and communication.** Some companies have started their risk culture initiatives with training and awareness programs. One executive outlined his approach saying, *"The campaign hit the entire company, at different levels through different mediums – not only town halls and executive committees discussing it but also poster campaigns about the three lines of defense."* He continued, *"What we wanted is training on risk culture and getting people to realize that you work for a bank, our business is risk, and all of our business is risk management – no matter where you are, there is an element of risk in everything you do … We're all risk managers."*

  A supervisor remarked, *"Training is a part of it, it's tangible … but just because [banks]* *document something doesn't mean there will be a cultural change, which as a supervisor is something you actually want."* An executive emphasized the importance, therefore, of coordinated, consistent reinforcement, saying, *"We didn't want to take a 'sheep dip' approach – a 'watch this video for five minutes and we're done' exercise. We wanted to reinforce it with discussion groups and town hall meetings with senior executives at various levels, and provided examples that we can share with people to make it real. That's a critical part of getting this across."*

"Training is a part of it, it's tangible … but just because [banks] document something doesn't mean there will be a cultural change, which as a supervisor is something you actually want."
– Supervisor

- **Compensation.** Risk-adjusting compensation practices, including increasing use of clawbacks and deferrals, has been a part of risk management improvements and garnered much attention. It is not yet a perfected science, and a supervisor stated, *"Job one is to make sure internal incentives are in line with where you want risk culture to be."* An executive concurred, adding, *"It is important to link risk to reward in a disciplined way. It needs to be outcomes - based … Values, principles, need to cut beyond the superficial to the outcomes."* Compensation can be a powerful communication tool.

"Job one is to make sure internal incentives are in line with where you want risk culture to be."
– Supervisor

- **Performance reviews and advancement.** Incentives extend beyond compensation. A director stated, "It all comes back to accountability and employees having that understanding of accountability and responsibility. Values have to be incorporated into the appraisal process." An important part of culture is "what people need to do to get ahead around here." After all, a director observed, "'who gets ahead' can be as important as 'who gets how much.'" An executive remarked, risk culture should be "embedded in [the] internal evaluation system – that clearly is being looked at with people's bonuses, but more importantly, it needs to be considered for promotion. Both are important, but the latter is more so – that you can demonstrate that you're at the highest echelons in these [risk culture] behaviors."

Banks and supervisors are refining approaches to understanding and assessing cultural effectiveness

Views among BGLN participants regarding assessing risk culture range from *"It is not that difficult,"* to *"It is devilishly difficult."* This range of perspective may be because, in some ways, assessing culture is about very simple concepts that are not very easy to measure in a formal way, or perhaps because "measuring culture" is itself a foreign concept to some. Culture deals with behaviors and attitudes that can be difficult to assess and interpret, and assessing it requires a great deal of judgment. Most participants acknowledge that data gathering can inform an assessment of culture, but truly understanding it requires considering the bigger picture – how the various pieces fit together, requiring discussions among senior executives, the board, and supervisors about potential trends or themes emerging from the data, and identifying root causes. Regardless, if an effective risk culture is essential, and if supervisors are increasingly going to be assessing it, banks need ways to provide evidence of that effectiveness and ways to identify issues that could be signs of cultural problems.

As a result, many banks are focused on developing and enhancing techniques to assess risk culture in a more systematic and precise way. As one director noted, *"You may have confidence in the banks' culture, but if you don't have evidence to provide a defense, you'll get into trouble if supervisors claim otherwise. If there's an issue, you will be unable to defend yourself because you don't have data – you can't just say it was a 'feeling'."* A recent EY survey found that "More than 85% of North American banks in the survey have programs in place to assess internal culture, and … In Europe and Asia-Pacific, 60% or more of banks have programs to assess internal risk culture."[10] Because risk culture involves a combination of formal and informal elements, efforts to assess culture need to integrate qualitative and quantitative indicators.

Developing a baseline understanding of gaps between desired and current risk culture

Once the desired risk culture is defined, conducting a gap analysis to understand where the current culture stands in relation to a firm's desired culture can provide a baseline for ongoing monitoring and assessment. One participant reported that they were *"conducting an inventory of the elements of risk culture to determine how we define it, and then where are the gaps and how do we close them?"* Ultimately, an executive said the objective is identifying *"ways to look at patterns of behavior and how they have been dealt with."*

Cultural surveys can be a good starting point to provide an enterprise-wide view of risk culture. One executive said they are *"improving existing risk culture surveys … [and] upgrading them with more risk-specific questions and other questions that correlate to risk behaviors and then measuring with quantitative metrics that give us insight into risk behaviors."* Despite their limitations, many see surveys as a useful source of data on risk culture. However, surveys, while useful, form only one part of the mosaic. As an executive said, *"You need a multidimensional approach … there are many pieces of the puzzle. You can't just do a survey and measure it, benchmark against other banks, write some nice words on the page, and then expect you'll get the outcomes you would like."*

> "Once the CRO is part of the power structure, the culture changes."
> – Director

Core questions for risk culture effectiveness

Understanding risk culture involves exploring answers to the following key questions:

- **What ultimately takes precedence in difficult decisions?** The key tests for risk culture are what ultimately takes precedence, revenues or risk, in reaching decisions on matters such as potentially lucrative, complex deals that test the envelope of what is or is not acceptable in terms of risk appetite. Documenting and tracking transactions and asking questions about the debate that goes into making those decisions can provide insight into the way risk is integrated into the discussion. Is the CRO truly integrated into the highest levels of management? A director said, *"Once the CRO is part of the power structure, the culture changes. Then you need statements, KPIs, systems underneath that. But it is very much about having risk integrated into the top management decision-making. Risk is totally integrated into the way top management decisions are made. To me, that is a clear sign of a strong risk culture."*

- **Do employees understand risk objectives and what behaviors are acceptable?** A supervisor noted, *"In assessing the espoused values, board and senior management should assess whether values are communicated throughout the organization and the tone at the middle is the same as the tone of the top."* Importantly, the officially communicated messages and policies should not be different from the implicit messages being delivered to revenue producers. So what are the informal mechanisms through which employees receive messages, and how do those messages compare to the official rhetoric? Do employees understand and abide by the spirit of risk parameters or look for opportunities to circumvent them? As a participant noted, *"Where there are gaps in the limit framework, then it is about judgment. Do you raise your hand in those cases, or optimize against the limits? When there are hard calls to make, you need a process for escalation."* Another participant said, *"It is fairly easy to spot: when individuals put forward things that don't fit with our risk objectives, you know risk culture is not embedded."* Employee exit interviews can be a useful way to get candid perspectives on these questions.

  A column in the *Financial Times* noted that when the next issue arises, "the question will not be whether bankers completed their training – they all will have – but whether they absorbed enough of the lessons to avoid the pitfalls many fell into last time."[11]

- **Are people really held accountable for culture?** The other side of accountability is consequential actions for those behaviors that are contrary to the desired risk culture of the firm. As one participant commented, performance often trumps risk issues: *"When was the last time you fired [someone] to demonstrate culture?"* What consequences do individuals and their supervisors face for compliance breaches? Are those consequences applied consistently, even when breaches result in revenue? What is included in the dashboard or scorecard? A director stated, *"We need to make sure we promote good leaders of people, not just good deal makers."* There must be evidence and understanding that, *"people can be fired, bonuses cut … and these instances, anonymized as appropriate, can be promulgated."*

> *"We need to make sure we promote good leaders of people, not just good deal makers."*
> – Director

Developing and refining cultural indicators

BGLN discussions suggest a possible framework that captures information and perspectives on (1) tone at the top and bottom of the bank; (2) behavioral metrics, such as the manner in which internal-audit recommendations are implemented, or the frequency and manner in which risk limits are breached; (3) the manner in which information or decisions are escalated within a bank; and (4) the manner in which rules and procedures are enforced and how transgressions are disciplined.[12]

As banks develop indicators, or metrics, some express caution about creating a new bureaucracy around risk culture creating unintended consequences. One executive cautioned, *"Some functions have blown themselves up because they're obsessed with measurement … the more you do it, the more noise you create. There's an army of people collecting measurements but you don't know which ones work."* A risk committee chair expressed the need for caution as well: *"I will be trying to get a few metrics into board reporting that are relatively easy, but it needs to be done with care – once you start measuring things, you start* *influencing them, and may have unexpected results."*

Some participants suggested much of the data and information about risk culture is already embedded in existing metrics and reporting, so it is possible to leverage existing processes: *"You can avoid creating a bureaucracy by integrating existing documentation into a framework."* A participant suggested, *"There is a massive amount of information – it's all there, but how do you identify the nuggets that really tell you something?"*

"There is a massive amount of information – it's all there, but how do you identify the nuggets that really tell you something?"
– Chief risk officer

Developing a core set of meaningful indicators for the board

Most banks are developing a number of indicators, some stemming from metrics already included in the risk appetite, others newly created to track culture specifically. But there is a broad range in terms of the number of metrics, the complexity of the metrics and related reporting, and the degree of formality and quantification. Most are identifying additional qualitative and quantitative risk-culture indicators that are highly correlated with risk behavior – both negative and positive indicators. These range from more quantifiable metrics, such as training completion rates, to things like the number of internal audit failures, to more qualitative measures, like the way internal audit reports or failures are treated by senior management, and the level of prior management awareness of risk as part of internal audit, etc., to those that attempt to highlight behavioral anomalies that could represent broader culture issues, such as traders not taking any vacation days or coming into the office at odd hours.

Identifying a small set of meaningful indicators that will be truly additive and provide enough information to the board to build a mosaic of the risk culture of the firm remains a challenge for most. As one participant said, boards already get *"too much data and not enough information."* One participant added, *"We are trying to keep it simple – having six metrics that really measure something rather than hundreds that don't."*

Identifying leading indicators

Additionally, identifying forward-looking indicators rather than after-the-fact incident reports is exceedingly difficult, with one executive saying that identifying *"leading indicators of vulnerable areas,"* was his most difficult challenge, adding that *"we have more than enough lagging indicators."* He went on to ask, *"What were the metrics that we should have been collecting that would have given an indication or raised flags much sooner when an incident occurs that points to a potential problem with risk culture?"*

Improving documentation and transparency

Some participants have improved documentation, a step taken to improve internal processes, but also to provide evidence for supervisors. Some fear that a focus on what is measurable and demanding increasing documentation may *"lose the plot."* For instance, one executive suggested a focus on documentation may actually obscure improvements in risk culture, saying *"Regulators want to know how many times people have declined a transaction. Well, if you are able to ensure people understand your risk appetite and respect limits, they will understand what they have to do so you won't see many declines."* Another elaborated, *"There are areas that you can see evidence of risk culture with documentation, but the fear is that it moves into only documentation."*

Still, documentation can be an important part of improving transparency – both about how risk is integrated into decisions and how people are being held accountable. An executive stated, *"Risk management and risk culture are increasingly* *important to the market, but credit rating agencies don't know how to measure it. We need to demonstrate that we are walking it, not talking about it. We need transparency, to disclose in meaningful ways."*

Developing a feedback loop to learn from past mistakes

Understanding *"how people behave when things go wrong,"* can offer useful insight. A participant commented, *"With bad outcomes, problems with culture become more evident, failures are always insightful."* They can also serve as an important tool for CROs and risk committees holding people accountable by conducting "postmortems," analyzing what happened and why, and whether the failure could be representative of broader trends, or an idiosyncratic incident. One executive remarked, *"It's important to tap into a set [of desired] behaviors and trying to reinforce them, but it was also looking at recent issues to distill lessons learned and then consider what could have made a critical difference."* Although, some participants cautioned that there can be *"hindsight bias in risk behavior"* and *"sometimes losses are just losses,"* it's important to ask, *"Were we aware of the risk and was it consistent with expectations?"* While boards have to review a lot of information, and can't review every incident, *"Incident reports can provide very useful insight, even small, specific incidents can tell you something. I would ask management about those. There may be trends."*

> *"With bad outcomes, problems with culture become more evident, failures are always insightful."*
> – Executive

Asking basic questions and looking for softer indicators

A director said it is *"the job of the board to hold a mirror up to the bank."* Effective board governance, it is often said, is about asking the right questions. Participants note that gaining insight into risk culture is no different. A supervisor observed, *"It is hard for a board to get a full view because all these pieces are moving. In the future they need to have more holistic discussions that give them a sense for the risk culture, rather than one-offs as incidents occur."* One director said they can ask, *"'How was your quarter?' If the answer is only about how much money we made, I would worry."* Another asked, *"Do people ever answer, 'I don't know,' to board questions? If not, I would be suspicious."* Other signs include how management talks about culture: *"Is it an HR topic, or a business topic?"* Boards can also look for signs about how well management understands the risks they are taking. One said, *"If someone is the smartest person in the room, but no one knows what they're talking about, and they make a lot of money, that is a sign."*

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A recent *Economist* essay observed, "As the impact of the crisis of 2008 subsides, leaving its legacy of unemployment and debt, it is worth asking if the right things are being done to support what is good about finance, and to remove what is poisonous."[13] Embedding sustainable risk cultures in global banks is a part of the objectives of improvements to risk management, governance, and supervision. As market conditions change, these efforts will be put to the test. An executive oberserved, *"We have put in all the building blocks, but we are now at a more interesting stage: developed markets are set to grow, at least as projected. That will be the test: how do you make sure culture is maintained? We have a generation of bankers that don't know how to grow a business properly with most of the 2000s as illusory growth based on leverage and mis-pricing risk. So how do you make sure you have the right skillsets, but also the right mindsets?"*

About the Bank Governance Leadership Network (BGLN)

The BGLN addresses key issues facing complex global banks. Its primary focus is the non-executive director, but it also engages members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy banking institutions. The BGLN is organized and led by Tapestry Networks, with the support of EY. *ViewPoints* is produced by Tapestry Networks and aims to capture the essence of the BGLN discussion and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, senior management, advisers, and stakeholders who become engaged in this leading edge dialogue, the more value will be created for all.

About Tapestry Networks

Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. To do this, Tapestry forms multi-stakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable, and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

About EY

EY is a global leader in assurance, tax, transaction, and advisory services to the banking industry. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients, and for its communities. EY supports the BGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.

Appendix: Participants in BGLN risk culture discussions

The following people have participated in bilateral or group BGLN discussions about risk culture since September 2013, including a meeting of risk executives, non-executive directors, and supervisors, in March 2014 in New York.

Bank directors and participants

BNY Mellon

- Don Gilmore, Former Chief Administrative Officer, Risk and Compliance
- Brian Rogan, Vice Chairman and Chief Risk Officer
- Kevin Smith, Chief Risk Officer, Asset Servicing
- Dean Stephan, Chief Operating Officer, Risk and Compliance

CBA

- Chris Horsley, Head of Transformation

CIBC

- Laura Dottori, Chief Risk Officer
- Nick Le Pan, Risk Committee Chair
- Leslie Rahl, Risk Committee Member

Citigroup

- Anthony Santomero, Risk Committee Chair

Credit Suisse

- Tobi Guldimann, Former Chief Risk Officer
- Anton van Rossum, Risk Committee Member

Deutsche Bank

- Stuart Lewis, Chief Risk Officer

Goldman Sachs

- Eugène Léouzon, Chief Risk Officer, EMEA

HSBC

- Rachel Lomax, Risk Committee Member
- Marc Moses, Chief Risk Officer
- Alan Smith, Global Head of Risk Strategy

ING

- Wilfred Nagel, Chief Risk Officer
- Robert Reibestein, Risk Committee Chair

Macquarie

- Stephen Allen, Chief Risk Officer
- Michael Hawker, Risk Committee Member

Morgan Stanley

- Keishi Hotsuki, Chief Risk Officer

RBC

- Mark Hughes, Chief Risk Officer
- Katie Taylor, Board Chair

RBS

- Andrew Lewis, Chief Administrative Officer, Risk and Restructuring
- David Stephen, Chief Risk Officer

Société Générale

- Benoît Ottenwaelter, Chief Risk Officer

Appendix: Participants *continued*

TD Bank

- Mark Chauvin, Chief Risk Officer
- Karen Maidment, Risk Committee Chair

UBS

- David Bawden, Head of Firm-wide Risk Control and Methodology
- Philip Lofts, Chief Risk Officer

UniCredit

- Alessandro Decio, Chief Risk Officer

U.S. Bancorp

- Rich Hidy, Former Chief Risk Officer
- Jerry Levin, Governance Committee Chair
- Bill Parker, Chief Risk Officer

Wells Fargo

- Keb Byers, Chief Enterprise Risk Officer
- David Marks, Executive Vice President, Head of Corporate Risk Program Office

Westpac

- Greg Targett, Chief Risk Officer

Regulatory participants

Australian Prudential Regulation Authority

- Brandon Khoo, Executive General Manager, Specialized Institutions Division
- John Laker, Chairman
- Ian Laughlin, Deputy Chairman
- Charles Littrell, Executive General Manager, Policy, Research, and Statistics Division
- Helen Rowell, Member

De Nederlandsche Bank

- Jos Heuvelman, Banking Supervision Division Director

Federal Reserve Bank of New York

- Michael Alix, Senior Vice President, Financial Institution Supervision Group
- Steven Manzari, Senior Vice President, Financial Institution Supervision Group

Federal Reserve Board

- Richard Naylor, Associate Director, Division of Banking Supervision and Regulation

Financial Stability Board

- Simonetta Iannotti, Member of the Secretariat
- Grace Sone, Member of the Secretariat

Swiss Financial Market Supervisory Authority (FINMA)

- Karl Rappl, Risk Management, Banks

Office of the Comptroller of the Currency

- Marty Pfinsgraff, Senior Deputy Comptroller for Large Bank Supervision
- Molly Scherf, Large Bank Governance Lead

Office of the Superintendent of Financial Institutions

- Julie Dickson, Superintendent
- Maria Moutafis, Managing Director, Corporate Governance

Prudential Regulation Authority

- John Sutherland, Senior Adviser

EY

- Ian Baggs, Global Banking & Capital Markets Deputy Leader, Financial Services
- Tom Campanile, Partner, Financial Services
- David Gallet, Executive Director, Financial Services
- Tom Huertas, Partner, Financial Services Risk Advisory

Appendix: Participants *continued*

EY *(continued)*

- Ted Price, Advisor, Risk Governance
- Bill Schlich, Global Banking & Capital Markets Leader

Tapestry Networks

- Dennis Andrade, Principal
- Jonathan Day, Senior Advisor
- Charles Woolcott, Associate

Endnotes

1 Emily Cadman, "IMF's Lagarde attacks financial sector for blocking reform," *Financial Times*, May 27, 2014.

2 *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of network participants and their corporate or institutional affiliations are a matter of public record, but comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.

3 Financial Stability Board, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture* (Basel: Financial Stability Board, 2014), 1.

4 Ibid., 1.

5 Ibid., 2.

6 EY, *Assessing Risk Culture – Questions Firms Should Be Asking* (London: EYGM Ltd., 2014), 2.

7 Financial Stability Board, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture*, 1.

8 Ibid., 2-4.

9 Bank Governance Leadership Network, *Five Years On, Uncertainty Is the New Normal*, ViewPoints (Waltham, MA: Tapestry Networks, December 2013), 22

10 EY and Institute for International Finance, *Remaking Financial Services: Risk Management Five Years after the Crisis* (London: EYGM, Ltd., 2013), 13.

11 Andrew Hill, "Bankers back in the classroom," *Financial Times*, October 16, 2013.

12 Bank Governance Leadership Network, *Seeking Progress on Risk Appetite Frameworks: Bridging Divides on Understanding, Implementation and Impact*, ViewPoints (Waltham, MA: Tapestry Networks, October 19, 2012).

13 *Economist*, "The slumps that shaped modern finance," April 11, 2014.