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Managing the People Side of Risk – Risk Culture Transformation

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Introduction

In the wake of the global financial crisis, banks have invested heavily to improve their risk models and to put in place more thorough processes and oversight structures in order to detect and mitigate potential risk. Yet, models, processes, and oversight structures – albeit essential – are only part of the story. In our experience, most risk incidents tie back to a cultural root cause, fostering inappropriate decisions and actions that result in losses. Crises can continue to emerge when organizations neglect to manage their people's attitudes and behaviors towards risk across all lines of defense.

In April 2014, the Financial Stability Board (FSB) stated that even though risk culture is a very complex issue, "… efforts should be made by financial institutions and by supervisors to understand an institution's culture and how it affects safety and soundness" (FSB report, "Guidance on Supervisory Interaction with Financial Institutions on Risk Culture," April 2014). By now, nearly all national regulators in North America and Western Europe have issued guidelines requiring banks to actively improve and monitor their risk cultures.

In this context, banks find themselves faced with three major questions:

- How should risk culture be defined?
- What is required to transform an organization's risk culture?
- How can an organization rigorously monitor progress on evolving risk culture towards a desired target state?

Traits of strong risk culture

Effectively tackling the issue begins with establishing a common language for how to talk about risk culture. We define risk culture as:

The mindsets and behaviors of individuals and groups within an organization that determine the collective ability to identify and understand, openly discuss, and act on the organization's current and future risks.

This definition is supported by 10 dimensions of risk culture, identified through dozens of in-depth case studies on the cultural root cause of risk incidents at leading institutions, globally coupled with an extensive review of academic literature. Underpinning this framework is a rigorous quantitative assessment of the strength of risk culture, which has now been deployed at over 30 financial institutions globally.

Exhibit 1 – RISK CULTURE ELEMENTS

Encouraging transparency

The best cultures actively seek information about and insight into risk through appropriate risk models, detailed risk reporting, and the establishment of a shared responsibility to communicate potential issues. A lack of transparency on current and future risk exposures not only hinders early risk mitigation, but can also prevent measured risk taking. The mindset of: "If we don't know, the answer is no," is a common reflex in organizations with low transparency, resulting in foregone opportunities and strife between business and risk functions.

At the same time, it is important to foster a common understanding of the boundaries of individual risk taking. A clear risk tolerance derived from an overall risk appetite statement and expressed in specific guidelines that limit which risks are allowed is one important element of a strong risk culture.

Acknowledging risk

It takes a certain confidence among managers to acknowledge risks. Doing so requires working through issues that could lead to crisis, embarrassment, or loss. The cultural difference between companies that acknowledge risk and those that do not is stark. Consider, for example, the difference between two global financial institutions we surveyed that take similar risks and share a similar risk appetite.

The first has built an organization wide culture that values proactive challenging of decisions, thereby encouraging discussion and learning from risk failures. The stance it takes is: "If we see it, identify it, and size it, then even if it's horrible, we will be able to manage it!" Where risks cannot be sized, they are at least discussed in qualitative terms. This institution has won the respect of regulators and built credibility with investors.

The second institution, in contrast, has evolved into a reactive and protective culture – one focused more on staying out of trouble. Its managers are generally content to move run with the pack on risk issues, preferring to wait for regulatory scrutiny or reprimand before upgrading subpar practices. They are afraid of what they don't know and, over time, have instilled in employees a fear that they will "shoot the messenger." This organization's stance is: "Let's wait until we really need to deal with these unpleasant things, because they might turn out to be nothing at all." They've experienced a wave of regulatory fines and now face an overhaul of their risk governance processes.

Responsiveness

The most effective organizations act quickly to move risk issues up the chain of command as they emerge. This requires well-defined, yet nimble risk escalation processes along with the willingness to break through rigid governance mechanisms to get the right experts involved whether or not, for example, they sit on a formal risk-management committee. Very often, responsiveness is bogged down by the very processes intended to support a strong risk environment – expectations on supporting data and committee protocol can swamp the ability to engage in productive discussion of emerging risks before they become prominent issues.

Responsiveness also requires instilling a cohesive sense of personal accountability at the individual level for risk management, across all lines of defense. Institutions that stand out in this regard embody a mindset of: "every manager is a risk manager," avoiding the trap of positioning the risk function as the "police department" of business behavior.

Ensuring respect for risk

Most executives understand the need for controls that alert them to trends and behaviors they should monitor in order to better to mobilize in response to an evolving risk situation. While too few controls can leave companies in the dark as a situation develops, too many can be equally problematic. More controls are often mistakenly equated with tighter management of risk. In one large hospital system surveyed, managers had implemented so many guidelines and controls for ward procedures that staff saw them as impractical. As a result, they routinely circumvented them, and the culture became increasingly dismissive of all guidelines, to the detriment of patients.

In the best of cases, respect for rules can be a powerful source of competitive advantage. A global investment company that took part in the survey had a comprehensive due diligence process and sign-off requirements for investments. Once these requirements were fulfilled, however, the board was prepared to make large, early investments. Companywide confidence in proceeding resulted from an exhaustive risk debate that reduced fear of failure and encouraged greater boldness relative to competitors.

Risk culture transformation

Banks that want to reshape their risk cultures should be aware that patience and persistence are crucial. Changing the operating environment of a large organization takes at least two to three years.

In our experience, the keys to a successful risk culture transformation are:

- Reaching a broad consensus on the desired risk culture that is linked to the linking into overall organizational culture.
- Reviewing formal mechanisms to enforce a strong risk culture and developing people capabilities related to dealing with risks.
- Overinvesting in communication and senior leadership role modeling.

Reaching consensus on culture

Improving a company's risk culture is a group exercise. No one executive – or even a dozen – can sufficiently address the challenge. A risk culture transformation must build broad agreement among a bank's top 50 or so leaders.

These leaders must first clearly define the kind of culture they want to build – expressed in four or five core statements of values. For one institution, this included the statement: "We will always understand the infrastructure implications of the risk decisions we make." As a consequence, the company needed to change the way it approved activities so that they no longer proceeded if the risk infrastructure did not support them.

A common pitfall is to define a desired risk culture and put in place a transformational program without considering the wider organizational culture. A bank's overall culture will significantly influence its risk culture. For example, a hierarchical leadership culture may make it difficult to foster openness and challenge across all levels. The link between desired risk culture and the overall organizational culture needs to be actively discussed among leadership. One option to ensure a proper linkage of risk culture to the overall organizational culture is to embed risk culture expectations into the general code of conduct.

Review formal mechanisms and capability building

To make aspirations for risk culture operational, managers must translate them into specific process changes across the organization. This includes changing the way governance committees function, adjusting key operating procedures, and modifying people processes such as training, compensation, and accountability.

While reengineering end-to-end processes takes time, creating a sense of urgency through a few symbolic, but highly visible actions can have a profound impact on a bank's culture. For example, in one global organization, a simple announcement that certain risk-related data would be incorporated into promotions radiated throughout the organization virtually overnight, encouraging some behaviors and discouraging others.

Beyond pay and promotion structures, the incorporation of risk culture elements in the full HR cycle is critical. An assessment of risk culture attitude should be incorporated into the recruiting process. A targeted, tenure-dependent capability building program for risk and nonrisk employees, based on real risk scenarios, can help reinforce key risk culture messages. Rotation programs are another way to build more extensive risk knowledge, with some institutions even going so far as to make a rotation in risk or compliance mandatory for senior leadership progression.

Communication and senior leadership role modeling

Proper communication across all levels is the key to ensuring sufficient awareness of potential risks and an associated good risk culture. Very often, a risk culture narrative that seems obvious to senior leadership is poorly understood by those just a few levels deeper in the organization. Investing the time to clearly articulate and cascade the desired target state can drive measureable impact. This includes finding ways to celebrate examples of good risk behaviors as well as creating the right "cultural PR" through town halls, different forms of employee communication, and leadership actions.

In our experience, the perception gap can vary dramatically across organizational levels. Even with explicit encouragement, employees often feel wary about stepping out of their comfort zones. Senior leaders at one leading bank were surprised to discover that while they rated their institution very strongly regarding openness to upward challenge on risk issues, those deeper in the organization did not. A behavior they welcomed and thought they were encouraging was, in fact, not perceived as safe. Altering this perception required initiating a dialogue about how challenge is expected and rewarded with mechanisms built into decision making to prompt the explicit discussion of what might be missing/what could go wrong.

From transformation to risk monitoring

Maintaining a strong risk culture requires constant vigilance, which in turn requires regular monitoring. Risk culture can and should be measured. Typically, a mix of different metrics needs to be applied to measure all aspects of risk culture. These often include:

- *Behavioral scores*, e.g., from annual surveys sampling employees about their views on a set of prevailing outcomes and practices along all risk culture dimensions.

- *Risk culture knowledge scores*, e.g., the share of employees that attended a risk culture training module, the frequency of risk-focused communications sent out by management.

- *Outcome-based metrics*, e.g., the amount of operational losses, the number of compliance incidents, the number of audit findings resolved in a timely manner, the number of risk limit breaches.

One bank introduced a "red flag system" in which managers issue red flags to employees for nonadherence to policies and procedures (i.e., not fulfilling mandatory training requirements on time, limit breaches, the use of unapproved models) with the specific number of red flags issued dependent on the frequency and severity of individual breaches ("risk weighting"). Red flags are then considered during performance reviews and constitute one of the criteria for decisions regarding individual promotions and compensation.

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For banks, a successful risk culture transformation should result in a lower number of risk/compliance incidents, lower operational losses, and a reduction in regulatory penalties. It is our contention that risk culture in banks can be defined and measured using a combination of tools. This enables specific interventions to be designed and deployed to shape a bank's risk culture and reduce the likelihood of breeches occurring in the future. Risk taking will remain central to bank operations. It is, therefore, important that management actively shape a risk culture in which these risks are managed and run, and that every employee, in accordance with the organization's risk profile, plays his or her part in protecting the institution from extraneous risks.

For bank leadership teams, understanding and developing risk culture is the key to becoming smarter and more agile. The stronger an institution's risk culture, the less it needs to rely on policies, procedures, and systems to manage and mitigate risk. For banks, a successful risk culture transformation is the first step in developing superiority in risk mitigation.

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