Cambridge Judge Business School

Centre for Risk Studies 7th Risk Summit Research Showcase

Regulating Risk Culture in Financial Services

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Regulating Risk Culture

- *'Unacceptable culture within firms was a major contributor to the financial crisis, and so regulators should play a greater role in judging how culture drives firms' behaviours and impact on society as a whole. The end goal should be that firms understand their own culture and the potential risks posed by the wrong culture'*

(Sir Hector Sants, UK Financial Services Authority, 2010).

Risk Culture in Financial Services

- Why regulate risk culture?

➢ Market failures:

✓ 2007-2009 financial crisis;
✓ LIBOR and Market Manipulation Scandals;
✓ Misselling of financial products;
✓ Banks circumventing sanctions/AMLs

Risk Culture in Financial Services

- "The leaders of our industry must collectively procure a visible and substantive change in the culture of our institutions … so as fundamentally to convince the world once again that they are businesses which can be relied on" (Mark Agius, former group chairman of Barclays).
- "Banks must undergo wholesale change in their culture and refocus their behaviour on meeting the needs of customers to restore trust in the industry" (Stephen Hester, former CEO of RBS Group).
- "Mistrust and the perception of inadequate standards have led to a crisis of confidence and it is severe. (…) We must not recoil from the shock waves, rather embrace the current reality and deliver the cultural change" (Sir David Walker).

Risk Culture in Risk Management

- Individual behaviour
- Ethical norms
- Company governance mechanisms

E Banks (2012)

Corporate Culture and Risk Culture

- Defining risk culture:
- ❖ Risk culture as a subset of the broader company’s organisational culture:
- ✓ ‘the norms and traditions of behaviour of individuals and of groups within an organization that determine the way in which they identify, understand, discuss, and act on the risks the organization confronts and the risks it takes’ (Institute of International Finance, 2009).
- ❖ Risk culture as everyone’s responsibility: from management to employees, thus:
- ✓ a system of values and behavioural norms which help foster risk management processes and ensure an adequate level of risk control.

Risk Culture under Regulatory Scrutiny

- Basel Committee on Banking Supervision (BCBS)
- Risk culture as a *'critical focus'* in banks' business strategies:
  - Member States are required to 'promote a sound risk culture at all levels of credit institutions and investment firms' (Directive 2013/36/EU).
  - Risk culture is a 'a bank's norms, attitudes and behaviours related to risk awareness, risk taking and risk management and controls that shape decisions on risks. Risk culture influences the decisions of management and employees during the day-to-day activities and has an impact on the risks they assume' (BCBS, Consultative Document: Corporate Governance Principles for Banks 2014).

Risk Culture under Regulatory Scrutiny

- Financial Stability Board (FSB):
  - ‘a sound risk culture bolsters effective risk management, promotes sound risk-taking, and ensures that emerging risks or risk-taking activities beyond the institution’s risk appetite are recognized, assessed, escalated and addressed in a timely manner’ (FSB, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture* 2014)
- European Systemic Risk Board (ESRB)
  - Sound and effective risk culture to prevent or reduce misconduct risk

Operationalising an Effective Risk Culture in the Financial Sector

- Role of the board: ‘setting the tone at the top’
- ✓ ‘Boards should identify and deal seriously with risky culture, ensure their compensation system supports the desired culture, discuss culture at the board level and with supervisors, and periodically use a variety of formal and informal techniques to monitor risk culture’ (Group of 30, *A New paradigm: Financial Institutions Boards and Supervisors* 2013);
- Effective firms’ supervision:
- ✓ Board and management of firms have responsibility on the firm’s cultural issues; supervisory authorities, on other hand, cannot determine culture; they should, instead, perform monitoring functions as to the effectiveness of a firm’s own culture to deter, *among other things*, bad behaviour. (G30, *Banking Conduct and Culture: A Sustained Call for Comprehensive Reform* 2015)

Systemic Impact of a Bank's Risk Culture

- Firms address risk culture from an internal perspective, whilst supervisors should address systemic implications of risk culture
- ➢ "culture and ethics are at the heart of banks' decisions in terms of risk-taking and safe and sound management practices. This means that understanding culture – what one does "when nobody is watching" – and ethics – the line between acceptable and unacceptable decisions – can help us to recognise, and even predict, some behaviours" (Danièle Nouy, Chair of ECB's Single Supervisory Board)
- Link between risk culture and prudential regulation
- ➢ Although it does not have any 'right culture' in mind, the UK Prudential Regulation Authority will act 'to tackle serious failings in culture through its normal activity, through use of its supervisory powers, and through enforcement action'.

Future Research Explores Macroprudential Implications of Risk Culture

- Scandals such as LIBOR and bank mis-selling of financial products has led supervisors to discuss risk culture in the context of ‘misconduct risk.’
- European Systemic Risk Board (2015) has analysed misconduct risk in the banking sector from a macro-prudential perspective.
- Research will analyse link between bank risk culture and risk management and how it can be a tool to control systemic risks.

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