

# Evolving risk culture

Cambridge Risk Summit

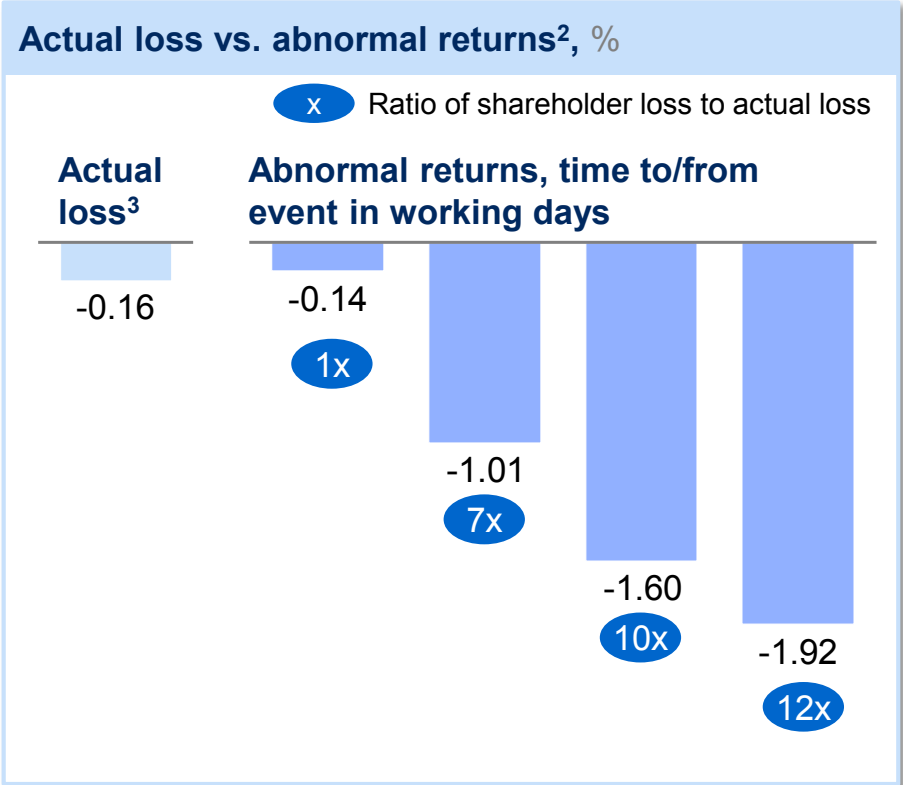
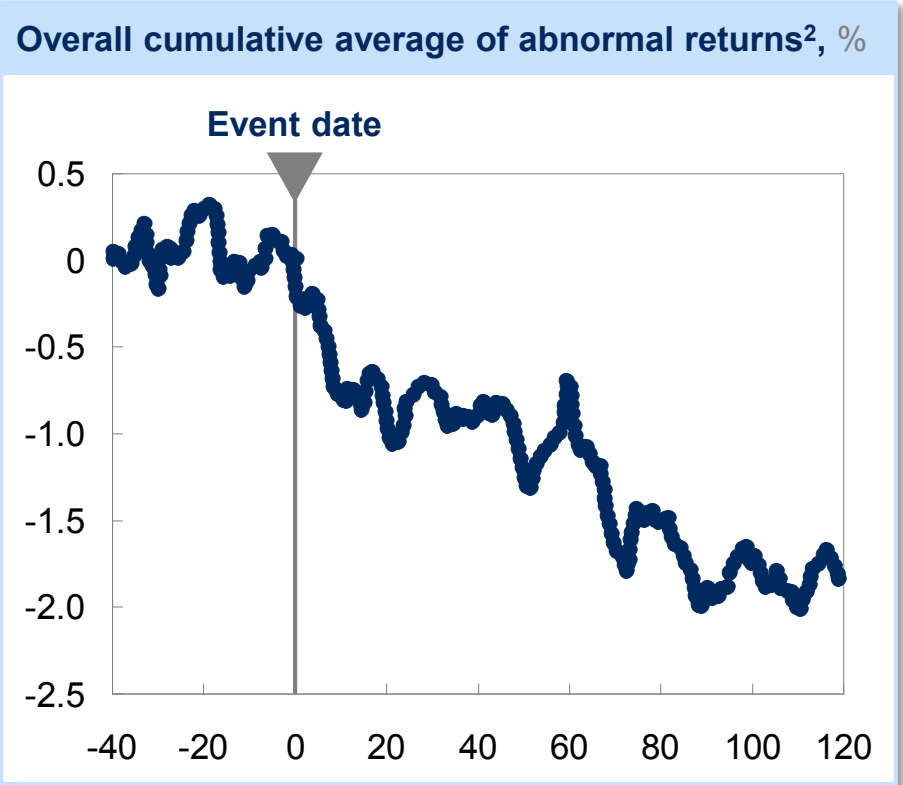
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# The value at stake of operational risk events is significant - the erosion of shareholder value can vastly outweigh the initial cost of risk events

Impact of operational risk event on market returns<sup>1</sup>



1 For 350 operational crises experienced by financial institutions in Europe and North America  
 2 Abnormal returns for each stock calculated daily as difference between actual and expected returns, adjusted for movements in broad market index; unweighted average of daily abnormal returns calculated across all operational-risk events to prevent "noise" of particular stocks from distorting overall results  
 3 As share of total market capitalization

# Behind every material operational risk event lies a cultural root cause

<p><b>2001</b> </p> <p><b>Event:</b> Organisational collapse and imprisonment of key executives</p> <p><b>Cultural root cause:</b> <b>Stifled challenge</b>, and an <b>over-confident</b> ‘profit is king’ mentality that tolerated people “beating the system”.</p>	<p><b>2004</b> </p> <p><b>Event:</b> Misrepresentation of oil and gas reserves by 20%</p> <p><b>Cultural root cause:</b> A culture of <b>over-confidence</b>, <b>no challenge</b> which <b>feared bad news</b></p>	<p><b>2008</b> </p> <p><b>Event:</b> Proprietary trading losses of €4.9bn</p> <p><b>Cultural root cause:</b> Lack of <b>internal challenge</b> coupled with <b>siload risk function</b> failure to communicate warning</p>
<p><b>2004</b>  <b>MERCK</b></p> <p><b>Event:</b> Loss of over \$30b in market value, multiple class action lawsuits</p> <p><b>Cultural root cause:</b> <b>Over-confident</b> and aggressive marketing of Vioxx, <b>lack of insight</b> around known clinical issues and slow response</p>	<p><b>2004</b> </p> <p><b>Event:</b> A superbug outbreak escalated, claiming 90 avoidable deaths</p> <p><b>Cultural root cause:</b> <b>Indifferent</b>, slow responding management, <b>lack of accountability</b></p>	<p><b>2008</b> </p> <p><b>Event:</b> \$37b housing market related writedowns</p> <p><b>Cultural root cause:</b> <b>Outflows of risk talent</b>, a lack of business-peer <b>challenge</b>, <b>siload risk functions</b> and an under-investment in risk processes due to <b>overconfidence</b></p>

# Increased regulator and policy maker scrutiny contributed to risk culture becoming a mainstream risk discipline for financial institutions

## Selected statements by regulators and policy makes

“**A sound risk culture consistently supports appropriate risk awareness, behaviours and judgements** about risk taking within a strong risk governance framework.”

– Report on 'Guidance on supervisory Interaction with Financial Institutions on Risk culture', Apr 2014

“**The PRA expects firms to have a culture that supports their prudent management.** ... The PRA considers a variety of factors to identify failings in culture, including governance, incentives, risk awareness and the ability to challenge senior management”

– The use of PRA powers to address serious failings in the culture of firms, Jun 2014

“**Competent authorities should assess whether the institution has a sound corporate and risk culture**, which is adequate to the scale, complexity, and nature of its business, and is based on sound, articulated values ...”

– Consultation Paper: Draft Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP), Jul 2014

## Selected statements by banks

“**We have to fix the culture** in the banking industry. The Board has also used all means possible to **ensure the gravity of this issue is reflected in the remuneration received by employees.**”

– Sir Philip Hampton, Chairman of Royal Bank of Scotland, Feb 2013

“We are **extremely concerned about conduct risk.** At board level, **we are going to give it much more explicit and deliberate attention. We will survey on a regular basis the culture of the bank.**”

– Sir David Walker, Chairman of Barclays, Feb 2013

“**Individual accountability is at the heart of our risk culture** — this means that each employee is responsible for understanding and complying with all applicable policies, completing all mandatory risk-related training, and for using his or her judgment to manage risk in their daily business activities.”

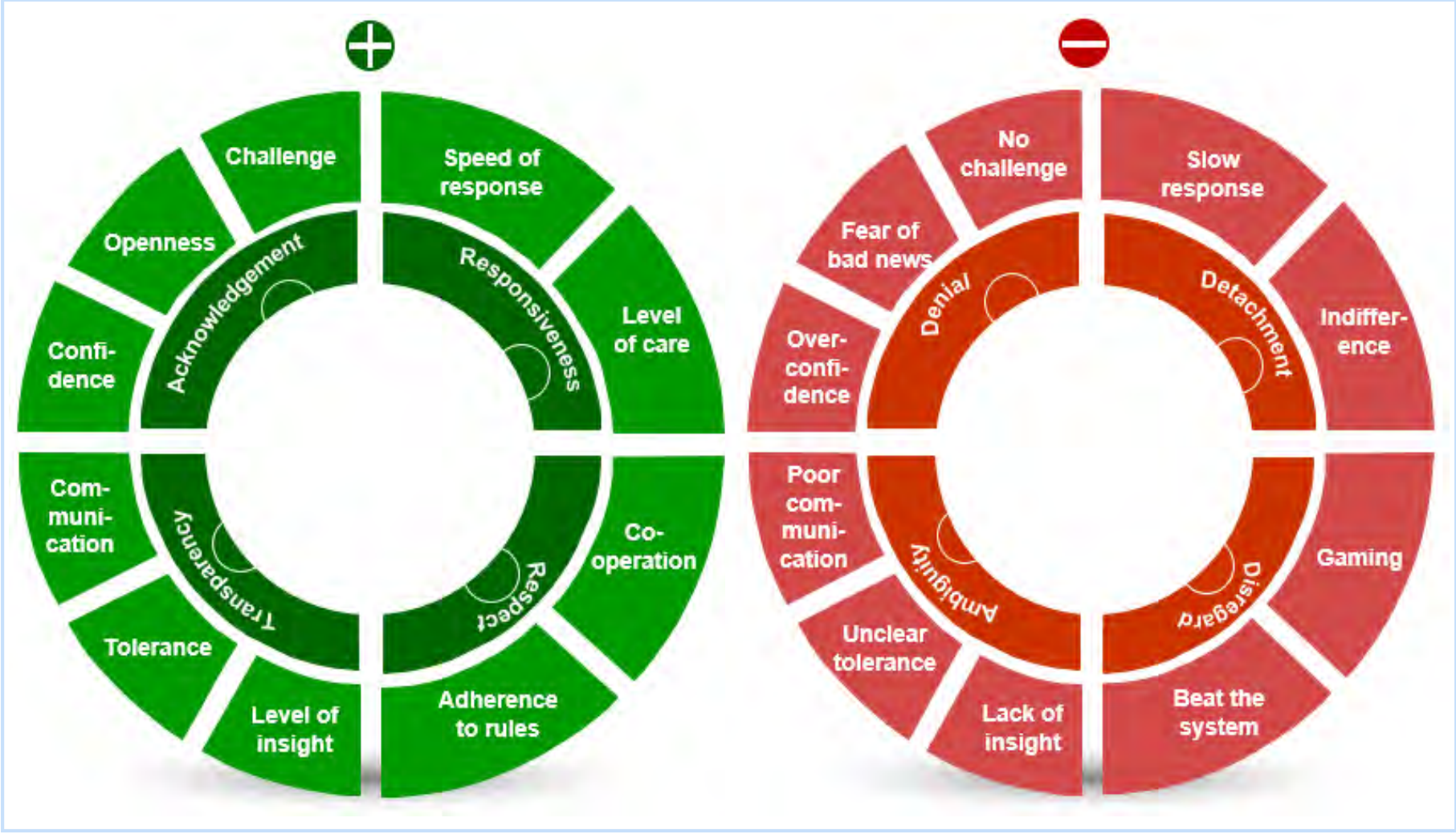
– Brian Moynihan, CEO of Bank of America, Jan 2014

# Initially most tried to achieve their desired risk culture by deploying a set of formalistic actions

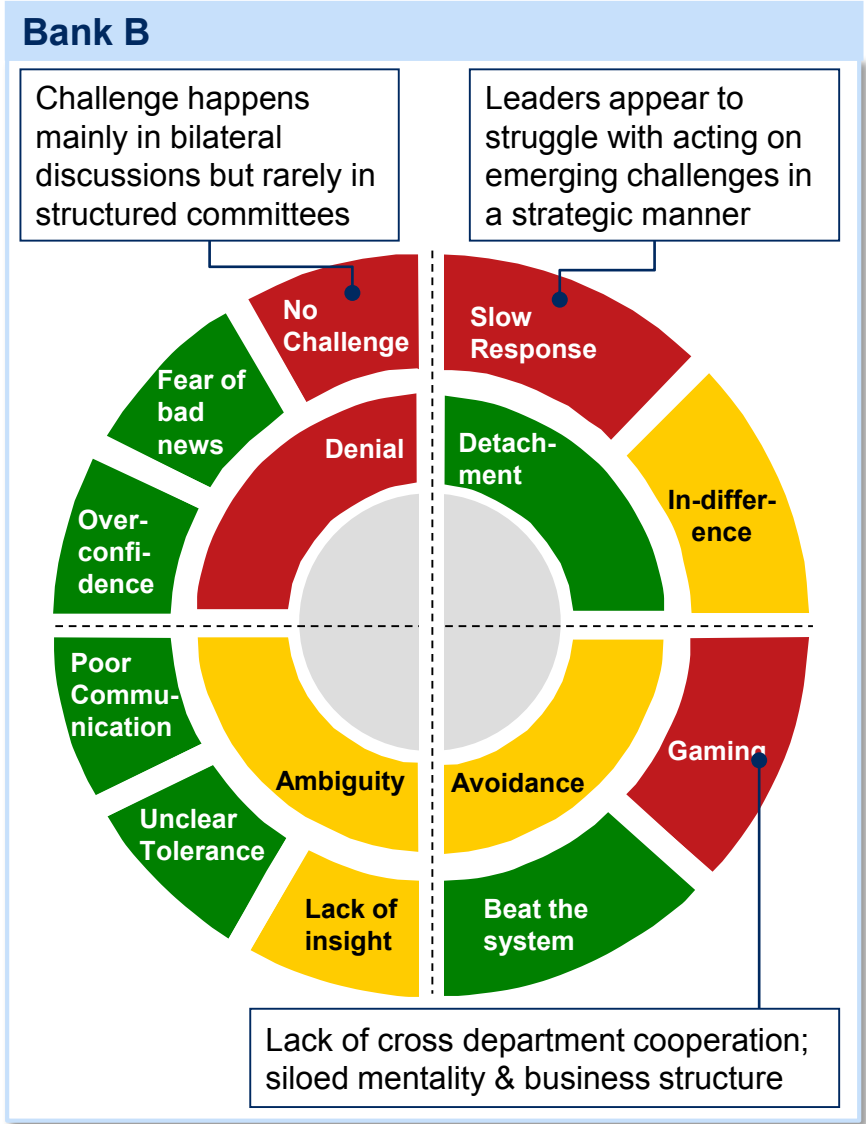
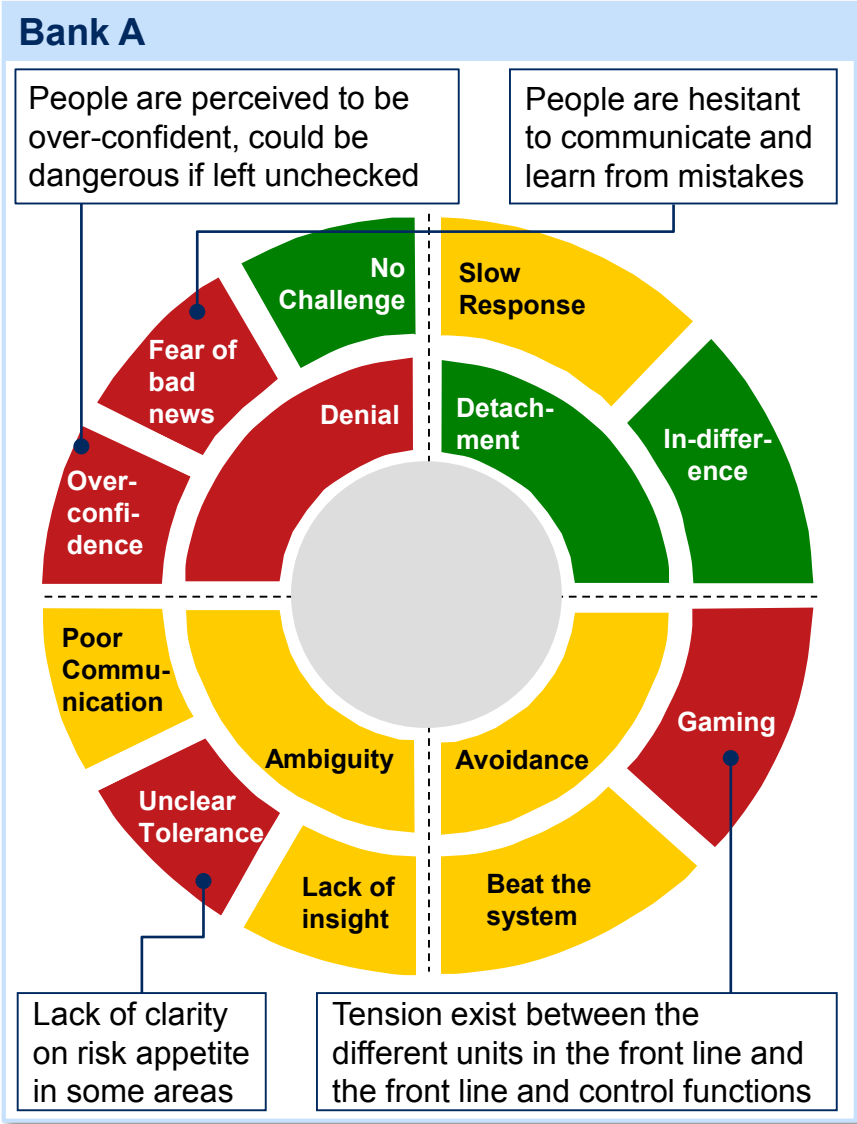
Risk culture checklist		
<b>1. Structure and governance</b>		
1.1	Regular discussion and reporting in Board risk committee	✓
1.2	Regular discussion and reporting in Enterprise risk committee	✓
1.3	Clarify risk roles and accountabilities	✓
1.4	Review risk committee membership	✓
1.5	Upgrade risk reporting enabled by IT automation	✓
<hr/>		
<b>2. Management Practices</b>		
2.1	Risk strategy process embedded in financial strategy	✓
2.2	Risk dialogue and reports in management meetings	✓
2.3	Scenario analysis	✓
2.4	Transparency of risk accountability	✓
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<b>3. Recruiting</b>		
3.1	Include risk knowledge requirements in position description	✓
3.2	Provide training in risk culture principles and expectations for new joiners	✓
3.3	Provide risk culture training for lateral hires	✓
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<b>4. Education</b>		
4.1	Include risk-related learning in education programmes	✓
4.2	Assess risk-related knowledge	✓
4.3	Create and assign risk-knowledge ratings	✓
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<b>5. Promotion and compensation</b>		
5.1	Include risk-related cases in performance assessment	✓
5.2	Include risk-management questions in performance dialogues	✓
5.3	Ask Risk leaders to screen promotion candidates	✓
5.4	Risk-adjust profitability figures to set the bonus pool	✓
5.5	Adjust individual reward based on risk culture red flags	✓

# Many are now trying to understand the behaviours and underlying mindsets that determine a good risk culture to address failure modes

McKinsey's risk culture diagnostic framework



# Example: Two investment banks that experienced material operational losses present very different risk culture failure modes DISGUISED EXAMPLES



# Next horizon to really move the needle for risk culture is to tackle 'signature' processes that impact day-to-day risk behaviours

Example bank process taxonomy (not exhaustive)

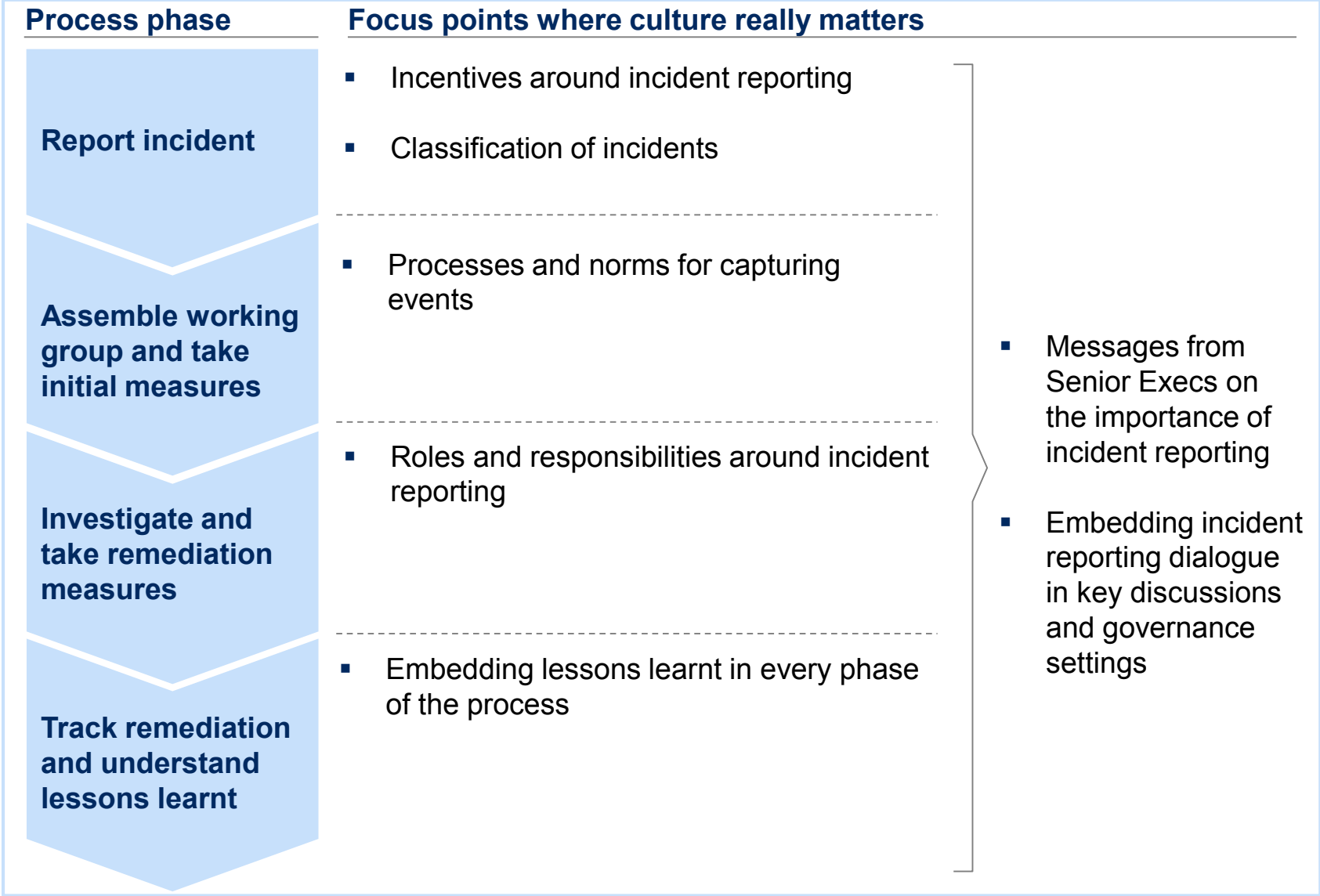
Primary process 'owner'

- Front office
- Middle Office
- Back-office

Retail	SME	Commercial	Risk	Conduct & Reg. Affairs	HR
<ul style="list-style-type: none"> <li>▪ Account opening/closing</li> <li>▪ Supporting customers with in-branch activities (deposits, payments, etc.)</li> <li>▪ Personal loan applications</li> <li>▪ Bereavement</li> <li>▪ Mortgage advice</li> <li>▪ Financial advice</li> <li>▪ Fielding Customer Inquiries</li> </ul>	<ul style="list-style-type: none"> <li>▪ New client acquisition</li> <li>▪ Relationship management</li> <li>▪ Selling transaction banking products (cash management, trade management, custody, safe-deposit box)</li> <li>▪ Selling lending products (loans)</li> <li style="border: 2px dashed orange;">▪ <b>SME transaction approval</b></li> <li>▪ Monitoring client financial status incl. potential needs compliance with loan agreements, etc.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Markets trade execution</li> <li>▪ Markets trade servicing</li> <li>▪ Pre-trade legal &amp; compliance</li> <li>▪ Sales &amp; trading of markets products</li> <li>▪ Trade flow management</li> <li style="border: 2px dashed orange;">▪ <b>Transaction approval for large exposure underwriting</b></li> <li>▪ ...</li> </ul>	<ul style="list-style-type: none"> <li style="border: 2px dashed orange;">▪ <b>New product approval</b></li> <li style="border: 2px dashed orange;">▪ <b>Credit Risk management</b></li> <li style="border: 2px dashed orange;">▪ <b>Enterprise Risk management</b></li> <li>▪ Liquidity/ALM management</li> <li>▪ Market Risk management</li> <li>▪ Operational Risk management</li> <li style="border: 2px dashed orange;">▪ <b>Incident management</b></li> <li>▪ Risk technology and operations management</li> <li>▪ Risk people, change and project management</li> </ul>	<ul style="list-style-type: none"> <li style="border: 2px dashed orange;">▪ <b>Compliance and Conduct Risk management</b></li> <li>▪ Policies, external stakeholders and regulatory management</li> </ul>	<ul style="list-style-type: none"> <li>▪ HR management &amp; support</li> <li>▪ Strategic functions</li> <li>▪ Transactional functions</li> </ul>
Finance	Communications & Marketing	Legal	IT	Operations	Client Servicing
<ul style="list-style-type: none"> <li>▪ Accounting operations</li> <li style="border: 2px dashed orange;">▪ <b>Financial planning and controlling</b></li> <li>▪ Management, systems &amp; support</li> </ul>	<ul style="list-style-type: none"> <li>▪ External communications</li> <li>▪ Internal communications</li> <li>▪ Management and support</li> <li>▪ Customer relationship management</li> <li>▪ Market presence</li> <li>▪ Product development</li> <li>▪ Product marketing</li> <li>▪ Safeguarding</li> </ul>	<ul style="list-style-type: none"> <li>▪ Legal group management</li> <li>▪ Litigation and counselling</li> <li>▪ Safeguarding</li> </ul>	<ul style="list-style-type: none"> <li>▪ Application development and maintenance</li> <li>▪ Project management</li> <li>▪ Package software implementation and support</li> <li>▪ IT Sourcing</li> <li>▪ IT Strategy and Planning</li> <li>▪ IT Operations</li> <li>▪ Data management</li> <li>▪ Architecture integration</li> <li>▪ Architecture design and management</li> </ul>	<ul style="list-style-type: none"> <li>▪ Cash and securities position management</li> <li>▪ Collections &amp; recoveries</li> <li>▪ Control and regulatory support</li> <li>▪ Fraud / AML Operations</li> <li>▪ Operations break resolution</li> <li>▪ Payment processing</li> </ul>	<ul style="list-style-type: none"> <li>▪ Account management</li> <li>▪ Client on-boarding</li> <li>▪ Client reporting</li> <li>▪ Complaint management</li> <li>▪ Dispute resolution</li> <li>▪ General products servicing</li> <li>▪ Incoming customer queries</li> <li>▪ Order management</li> </ul>



# Example: Focus points for risk culture in the incident management process



# Example: Risk culture assessment of the credit underwriting process at a large universal bank

DISGUISED EXAMPLE

- Strength
- Some areas of concern
- Weakness

Credit process stage	Risk culture assessment				
	Level of insight	Openness	Challenge	Adherence to rules	Cooperation
1. Deal origination and structuring	Weakness	Weakness	Some areas of concern	Some areas of concern	Weakness
2. Preparation of credit application	Some areas of concern	Some areas of concern	Some areas of concern	Some areas of concern	Some areas of concern
3. Identification of legal risks and recommendations on how to mitigate/eliminate	Strength	Some areas of concern	Some areas of concern	Some areas of concern	Strength
4. Collateral evaluation	Strength	Some areas of concern	Some areas of concern	Some areas of concern	Strength
5. Business reputation checks	Strength	Some areas of concern	Some areas of concern	Strength	Strength
6. Credit analysis	Weakness	Weakness	Some areas of concern	Some areas of concern	Weakness
7. Independent evaluation of credit risks	Some areas of concern	Some areas of concern	Some areas of concern	Strength	Strength
8. Decision-making (credit committee)	Some areas of concern	Some areas of concern	Weakness	Strength	Strength
9. Preparation of final documentation	Some areas of concern	Some areas of concern	Some areas of concern	Strength	Strength
10. Back office support	Strength	Some areas of concern	Some areas of concern	Strength	Strength
11. Monitoring	Weakness	Some areas of concern	Some areas of concern	Some areas of concern	Some areas of concern

In some instances, RMs may place business unit or personal interest before those of the Bank. For example

- Delay reporting of client's early indicators of financial distress
- "Helping" clients to fine tune credit application disclosing important details of bank's credit models

Transaction structuring with a view to obtain approval without involvement of other teams

Often a formalistic and fragmented approach to transaction analysis by all parties involved

# McKinsey has a proprietary assets and expertise to diagnose risk culture and design pragmatic interventions

**Pioneering tool for diagnosing and delivering real insights on risk culture**

- Survey with **56 standard questions** & free text questions
- Database of **70 clients with 150,000 responses**
  - ~ 50+ Financial institutions; ~ 15 Corporates
- It was **selected by the PRA** as the model approach for rigorous risk culture measurement in the banking industry



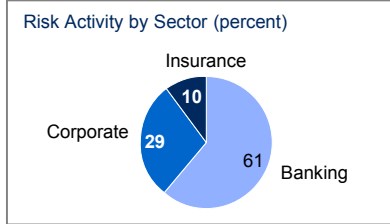
**Comprehensive library of risk culture Interventions**

- **Library of pragmatic actions** to put in place to close risk culture gaps, including a mix of 'hard' and 'soft' interventions:
  - Processes and structure
  - Capability building
  - Role-modelling and leadership



**Strong client track record across industries**

- **~2,000 studies** completed in the last 5 years on risk topics including ERM and risk strategy, organisation, compliance and operational risk, regulation, commercial risk, portfolio management and restructuring/crisis management and **~70 risk culture engagements**



**Dedicated global experts and advanced analytics team**

- **~100 dedicated Partners and 200 experts** on risk topics including experts with strong industry experience,
- Dedicated risk culture **global service line** and **risk diagnostics** team managing risk culture and other proprietary assets & benchmarks

