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Risk Culture

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2.1 Introduction

Studies on corporate culture have been carried out for a long time. Corporate culture has been a popular management tool since the early 1980s and, more recently, an intense activity of research on this subject (arisen from the failure of traditional cultural models) turned cultural explanations into a more valuable asset than a simple matter of “claiming the residuals” (Zingales 2015).

In the last decades, the market saw a clear evolution of the role of banks, passed from public institutions to profit-driven private entities. A new competitive environment, in terms of actors, rules, geography, and products, produced an evolution of corporate culture in banking. In this framework,

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A. Carretta et al., *Risk Culture in Banking*, Palgrave Macmillan

Studies in Banking and Financial Institutions,

DOI 10.1007/978-3-319-57592-6_2

risk culture can be seen as a subculture with a central role in financial institutions. This Chapter provides an introduction to the concept of risk culture, focusing on its definition, importance, and effects on bank competition and financial stability. It includes an in-depth analysis of the relevant literature and of good/bad practices. This Chapter is structured as follows:

- Definition and measurement of corporate culture and its impact on corporate behaviors;
- Presentation of the scope and alternative definitions of Risk culture;
- Analysis of drivers and effects of risk culture on sound and prudent management of financial institutions;
- Discussion on main challenges in deploying an effective risk culture.

2.2 What Corporate Culture Is and Why It Matters?

Literally speaking, there are many thousands of definitions of corporate culture, all sounding subtly different. Literature often refers to corporate culture as the missing link to fully understand how organizations act (Kennedy and Deal 1982). Culture is the result of shared values, basic, underlying assumptions and business experiences, behavior and beliefs, as well as strategic decisions. Culture is much more than a management style: it is a set of experiences, beliefs and behavioral patterns. It is created, discovered or developed when a group of individuals learn to deal with problems of adaptation to the outside world and internal integration. Individuals develop a system of basic assumptions proven to be valid by past experience. Members of the same group assimilate these assumptions, which become the organization's specific way to perceive, think, and feel in relation to problems (Schein 2010). Organizational culture deals with different approaches. One takes into account external outputs: environmental, architectural, technological, office layout, dress code, behavioral standards (visible and audible aspects), official documents (statutes, regulations, and internal communication), and symbols. Such an analysis is the necessary basis for investigating principles, knowledge, and experiences that guide attitudes and behavior. These

aspects reflect the internalized core values of the organization and justify the behavior of individuals. In fact, basic assumptions which underlie actions are often hidden or even unconscious: beliefs determine the way in which group members perceive, think, feel, and therefore, act but are difficult to observe from an outside perspective (Carretta 2001).

Culture is more complex than other organizational variables: it can be extremely effective and at the same time resistant to the need for change dictated by the environment (Fahlenbrach et al. 2012). Culture is, in fact, “what you do and how you do it when you are not thinking about it”. If well governed over time, it can be the glue that holds together a company.

Culture has always been considered a key tool affecting corporate behavior, but authors do not agree on *how* this occurs. Some consider culture as a fixed effect on firm performance, while others argue that it is a variable that can be managed over time. Viewing culture as a variable is a quite recent fact, and several institutions have developed proper management tools and frameworks to measure and manage it.

The discussion is still going on, but, in principle, a culture suitable for being applied to a business formula makes a significant contribution to business performance. A suitable culture implies that people “make use” of the same assumptions and adopt behavior inspired by the company’s values; this increases the market value of the company identity. In business, the importance of maintaining behavior consistent with corporate culture needs to be constantly stressed, especially by “leaders”, at all levels of the organization. The management should always remind the staff of the underlying cultural contents and their positive impact on individual and organization performance, by setting good example and communication. According to economic literature, culture is a mechanism in such a way that makes the corporation more efficient through simplified communication and decision-taking process. From this perspective, a strong culture has high fixed costs but reduces its marginal costs (Stulz 2014).

The fact that culture can be structured as artifacts, values, and assumptions implies different levels of analysis and assessment. The purpose of analysis requires a specific level of assessment and the most appropriate methodology. However, researchers should keep in mind that the study of only the visible manifestations of culture is likely to describe “how” but

not “why” (Carretta 2001). And as noted by Karolyi, there is a fragility in the measures of the cultural values available to us (Karolyi 2015).

A number of survey methods and metrics are used, among others, by firms to investigate the mind-sets underlying culture (See Box 2.1).

Box 2.1—Measuring culture and cultural progress: Range of approaches used by firms

Employee engagement and culture survey

Most firms use annual employee engagement surveys, supplemented by culture and climate surveys or modules added to the regular engagement survey

Customer perceptions and outcomes

According to some firms, the real test of culture consists in the outcomes it generates. The focus is particularly on customer satisfaction scores, while other firms even try to test outcomes (e.g., mystery shopping or regular online panels of customers)

Indicator dashboard

Several firms use a range of indicators, sometimes consolidated into “culture dashboards”, including:

- Customers: satisfaction scores, complaints
- Employees: engagement scores, speaking up scores, turnover, absence rates, grievances, use of whistleblowing lines
- Conduct and risk: conduct breaches, clawbacks, material events, and escalations

Validation

Firms use a range of methods to validate progress or performance and confirm understanding:

- Consultancy firms’ benchmarking exercises
- Other external benchmarks
- Internal Audit assessments
- Triangulation across various data sources, e.g. staff and customer surveys

Source Adapted from Banking Standards Board (2016)

In academic literature, there are some relatively well-established approaches to measuring culture. Qualitative methods are the ethnographic analysis and the case study, which allow an in-depth investigation, but at the same time limit the comparability of results.

According to Schneider (2000), direct observation is the only way to understand culture, since many of its aspects are silent. In addition, people within an organization are not aware of how many assumptions affect their behavior and take for granted that it applies to everyone in the sector. Furthermore, cognitive beliefs of researchers may influence their evaluation capacity. As a consequence, a problem of objectivity prevents the possibility for other researchers to replicate the analysis and confirm its results.

On the other hand, quantitative methods use standardized approaches of analysis through statistical tools. These methods do not provide in-depth observations but are more objective and allow the comparison of different situations.

The goal should be to create a homogenous method within organizations or groups of intermediaries, capable of reflecting the needs of companies and of the environment. This would result in a comparable approach compliant with the regulatory environment. Quantitative methods have been primarily used to evaluate culture indirectly, by observing developments in risk governance and the link between risk governance and the company's risk-return combinations (Ellul and Yerramilli 2013; Lingel and Sheedy 2012; Aebi et al. 2012).

A new and dynamic environment, in terms of actors, rules, geography, and products has produced an evolution of corporate culture in the banking sector. In the last century the market saw a clear evolution of the role of banks, passed from public institutions to profit-driven private entities. For some countries, this shift was very difficult and driven by an incisive, market-oriented intervention by regulators, especially in Europe, where the final goal was the creation of a common market. Prudent regulation has increased the range of banking services offered and, indirectly, competition. In order to prevent excessive risk-taking, the Basel Committee has promoted the "self-regulation" of intermediaries, setting up a system of internal controls and a new compliance function. The new culture of supervisors is based on the collaboration with banks and this relationship may have positive effects in terms of bank performances (Carretta et al. 2015). The financial behavior of families and firms, traditionally the main banking clients, has also undergone rapid changes. Family propensity to save has decreased. Families today

tend to invest more in financial instruments inside or outside their home countries, while firms are adopting new forms of financing, by acting directly on the capital markets.

These underlying shifts demonstrate the importance of studying the effect of corporate culture on banks' performance and competitiveness. The literature on banking culture focuses on the existence of a specific culture and on how it reacts to the new paradigms, showing that culture creates value in firms, and especially in banks. In an ever-changing market, credit supply and screening remain the most important activities undertaken by banks and represent a basic know-how. This comes from experience and the «mutual commitment based on trust and respect» (Boot 2000), which are the expression of a specific bank's culture.

In some cases, culture in the financial institutions has demonstrated the ability to integrate companies' know-how and new market opportunities. For example, the entry of banks into the insurance business was difficult, due to limited experience with sophisticated products. On the other hand, insurers had limited experience with bank retail client requirements. The problem was solved through successful strategic alliances in which banks used their distribution capacity and insurers developed simpler products. Culture has also driven the creation of new approaches to answer increasing competition. A “culture of distribution” has replaced the pre-existing “culture of production”. Due to this change, management has shifted the focus from an efficient service development towards an effective selling system. This new perspective is centered on creating unique and personalized conditions to attract the highest possible number of clients.

In the new context, culture is a resource rather than a limitation. If adequately taken into consideration, it can ensure the success of complicated events such as mergers and acquisitions. The “one size fits all” solution is not valid anymore, and despite cultural integration is never easy, effective management is the only chance to make it successful (Carretta et al. 2007). Part of the literature considers culture as a static element to be developed only in the long-term, but many authors and practitioners highlight that culture may be used in order to improve firm performance and stability. Nowadays, it is particularly difficult to

develop and implement a strategy due to the intrinsic variability of the market, with controls becoming increasingly complicated due to a wider range of bank activities and functions. In this context, culture can create shared values to drive individual behavior in pursuing the organizational strategy and assisting the role of internal controls.

To conclude, a specific corporate culture exists in the banking sector and literature shows that, in specific contexts, it can change and help bank stability. Empirical studies confirm it (Carretta 2001): positive relations with the environment are linked with an open culture. Banks have overcome their previous specialization, developing various new internal competences: integration, teamwork, and interpersonal relations are the base for a new model of leadership. However, the results also show that this new culture is not yet widespread.

2.3 Risk Culture: Scope and Definition

The Oxford Dictionary defines risk as a situation that involves exposure to danger. Particularly dangerous exposure is called bad risk. But banks, as well as any other firm, have the same opportunities to take risks of an ex ante reward on a stand-alone basis. This risk is being called “a good risk”. One might be tempted to conclude that good risk management reduces the exposure to danger. However, this view of risk management ignores the fact that banks cannot succeed without taking risks that are ex ante profitable. Consequently, taking actions that reduce risk can be costly for shareholders when lower risk means avoiding higher risk valuable investments and activities. Therefore, from the perspective of shareholders, valuable risk management does not reduce risk in general, since reducing risk would mean not taking on valuable projects. If good risk management does not mean low risk, then what does it mean? How is it implemented? What are its limitations? What can be done to make it more effective? (Stulz 2014). These questions can be answered by looking at the concept of risk culture.

Some authors define risk culture (RC) as an element of corporate culture; it is what in the culture relates to risk (Power et al. 2013). It is a product of organizational learning concerning what has or has not

worked in past investments and procedures of a financial institution (Roeschman 2014). RC could be seen as a subculture with a central role in financial institutions. In fact, the culture of an organization is neither unique, nor uniform throughout the company (Schein 2010). The growing complexity of operations, roles, and activities performed by firms produces different subcultures at all levels of the organization; for example, the point of view on the environment taken by the risk management department can substantially differ from that taken by the business line. In this case, RC interacts with dominant corporate culture and subcultures to ensure a continuous balance between the need for integration and the opportunity for differentiation of these two perspectives. This balance is the basis for the adaptation to the environment and for business changes. Box 2.2 presents a selection of the existing definitions for RC in financial institutions; the main ones are by FSB, Institute of International Finance (IIF) and Institute of Risk Management (IRM). These institutions use concepts that are widely used in literature to define corporate culture, such as values, norms, ethics, and traditions. The FSB and IIF definitions are very similar; in fact, both define RC as norms and behavior related to how individuals identify, understand, discuss (risk awareness), and act (risk-taking and management) concerning the risks. The IRM definition, on the other hand, refers to values and beliefs, and is in line with previous literature, which asserts that *basic assumptions* (beliefs) are at the heart of culture (Schein 1990).

Box 2.2—Risk culture definitions

Risk culture can be defined as the norms and traditions of the behavior 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*).

«A bank's norms, attitudes, and behavior 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» (*Financial Stability Board 2014; Basel Committee 2015*).

«Risk Culture is a term describing the values, beliefs, knowledge, and understanding about risk shared by a group of people with a common

purpose, in particular, the employees of an organization or of teams or groups within an organization» (*Institute of Risk Management 2012*).

«Barclays risk culture is the set of objectives and practices, shared across the organization, that drive and govern risk management (*Barclays PLC*).

Number of levers are used to reinforce the risk culture, including tone from the top, governance and role definition, capability development, performance management and reward» (*Lloyds Banking Group*).

«Risk culture is characterized by a holistic and integrated view of risk, performance, and reward, and through full compliance with our standards and principles» (*UBS*).

«It can be defined as the system of values and behavior present throughout an organization that shapes risk decisions. Risk culture influences the decisions of management and employees, even if they are not consciously weighing risks and benefits». (*Farrel and Hoon 2009*)

«The behavioral norms of a company's personnel with regard to the risks presented by strategy execution and business operations. In other words, it is a key element of a company's enterprise risk management framework, albeit one that exists more in practice than in codification» (*Smith-Bingham 2015*).

«Risk culture encompasses the general awareness, attitudes, and behavior of an organization's employees toward risk and how risk is managed within the organization. Risk culture is a key indicator of how widely an organization's risk management policies and practices have been adopted» (*Deloitte Australia 2012*).

Concluding, RC is composed of underlying assumptions and the way they turn into norms, values, and artifacts. Not all assumptions are relevant, but only those about risk or, more precisely, those that affect «the way in which they identify, understand, discuss, and act on the risks» (*IRM 2012*). So, RC is related to «risk awareness, risk-taking and risk management, and controls that shape decisions on risks», which act at all levels of the institution «during the day-to-day activities and have an impact on the risks they assume» (*FSB 2014*).

2.4 Risk Culture: Drivers and Effects

First of all, RC depends on national culture and environment. As far as culture is concerned, some countries are more homogeneous than others, even though sometimes, areas having a similar culture are part of

different nations. Despite these limitations, comparing national cultures is still a meaningful and revealing venture and has become part of the main social sciences. Research by Hofstede has shown that national cultures differ particularly at the level of habitual, unconscious values held by the majority of a population. According to Hofstede, the dimensions of national cultures are rooted in our unconscious values. Provided that these values are acquired in childhood, national cultures are remarkably stable over time; changing national values is a matter of generations. Instead, practices change in response to the changing circumstances: symbols, heroes, and rituals change, but underlying values are largely untouched. For this reason, differences between countries have such a remarkable historical continuity.

Similarly, culture is very much a product of the environment (Lo 2015). The International Monetary Fund has published empirical evidence covering about 50,000 firms in 400 sectors in 51 countries, according to which firms operating in countries characterized by lower aversion to uncertainty, greater individualism and sectors with a strong opacity of information such as the financial world have a more aggressive risk culture, and “even in a highly-globalized world with sophisticated managers, culture matters” (Li et al. 2013). Furthermore, these aspects will be discussed in the following subsections: the impact of regulation and its underlying culture (Carretta et al. 2015), as well as supervision pervasiveness of a company’s risk culture (Power et al. 2013). In the financial system, supervisors and supervised parties can collaborate in order to improve the culture of risk, fully aware that it is a sensitive area requiring time and resources (Senior Supervisors Group 2009; Group of Thirty 2008).

Culture directly impacts on corporate risk-taking not merely through indirect channels such as the legal and regulatory frameworks (Mihet 2012).

Risk culture also impacts on characteristics and behavior of a firm and at the same time is an expression of them. Over time (Fahlenbrach et al. 2012), it can regulate the possibility for businesses to adapt to the changing environment, but it may also change if it is no longer able to solve an organization’s problems (Richter 2014). Therefore, it will only affect the role of risk management in the organization; even in case of highly sophisticated and formalized risk governance,

risk culture is still in charge of deciding which rules and behavior are important (Roeschmann 2014; Stulz 2014). As a mechanism of control over behavior, risk culture can impact on results, and if it is strong and in a stable environment, it can become more persistent over time (Sørensen 2014).

The organization is perhaps the “elementary unit” for the analysis of culture (Carretta 2001) and risk culture, but the individual is the unit in terms of personal integrity and propensity towards risk. High levels of perceived integrity are positively correlated with good incomes, in terms of higher productivity, profitability, better industrial relations, and a higher level of attractiveness to prospective job applicants (Guiso et al. 2015), but individual behavior appears to be influenced by both context and professional identity which, once more, confirm the key importance of the organization (Villevall 2014).

Obviously, risk culture can appear in different forms as subcultures, or even conflicting countercultures, in the following areas: type of risk (i.e., credit or market), business functions and families in which it develops, prevailing business models, roles in bank’s overall corporate governance (i.e. shareholders, board of directors, management, and auditors).

Subcultures may exist depending on the different contexts within which parts of an institution operate (See Box 2.3). However, subcultures should adhere to the high-level values and elements that support an institution’s overall risk culture. A dynamic balance is required between the value generated by the differences in risk perception and that generated by a unitary risk approach.

Box 2.3—The Macquarie University Risk Culture Scale

The Macquarie University Risk Culture Scale was used to assess the culture in 113 business units across three large banks, two headquartered in Australia and one in North America.

The main findings were as follows:

- Strong risk culture was generally associated with more desirable risk-related behavior (e.g., speaking up) and less undesirable behavior (e.g., manipulating controls).
- Personal characteristics were also important. Long-tenured and less risk tolerant employees, and employees with a positive attitude towards

risk management were more likely to display desirable risk-related behavior. Those with high personal risk tolerance were more likely to display undesirable risk-related behavior.

- Good risk structures (policies, controls, IT systems, training, and remuneration systems) appeared to support a strong culture and ultimately a less undesirable risk behavior. Good risk structures did not by themselves guarantee good behavior. Early results suggested that structures such as remuneration were interpreted through the lens of culture.
- Senior staff tended to have a significantly more favorable perception of culture than junior staff. This highlighted the importance of anonymous and independent risk culture assessments where staff felt safe to reveal their true beliefs.
- There were statistically significant differences between the risk cultures of the three large banks analyzed.
- The majority of business units assessed (more than 95% of 113) had an internally consistent perception of culture, namely, there was a strong or obvious culture in the unit (i.e., not just the perception of an individual but a quality of the group). However, it should be noted that there might have been agreement on the fact that culture was good or poor.
- The most significant variation in risk culture scores occurred at the business unit level and seemed to be driven by the local team environment. This was consistent with the hypothesis that culture was a local construct highly dependent on interactions with close colleagues and immediate managers.

Source Adapted from Elizabeth Sheedy and Barbara Griffin, Empirical Analysis of Risk Culture in Financial Institutions: Interim Report, Macquarie University, November (2014)

2.5 Change and Challenge: Deploying an Effective Risk Culture

Risk culture is not a static thing but a formal and informal process continuously repeating and renewing itself. Risk culture, as well as corporate culture, evolves over time in relation to the events that affect an institution's history (such as mergers and acquisitions) and to the external context within which it operates.

Building a sound risk culture is a collective process, not simply a matter of improving technical skills. Risk culture shall be a part of a business and not simply of the supervision, which is not necessarily a good proxy. Therefore, it concerns decisions and actions on a daily basis, such as the way information is shared, the people being asked, when something went wrong, the capacity to represent risk inside the organization and the understanding and correct use of documents. It also includes what “worked” in the past. With the changing of both external and internal conditions, culture too changes along with a strategic change (See Box 2.4). Obsolete business culture is an obstacle to improving performance.

The Group of Thirty (2015) states that culture and behavior in today’s financial systems and institutions are inadequate. An important finding is that a suitable culture, with particular regard to risk, is not a critical success factor but is displayed only to meet the expectations of a public, customers or norms at particular times. It is not central to governance organs or senior management. It is not sufficiently rewarded in performance management and does not feature in bank personnel training. It does not dialogue with three lines of risk defense, (business, supervision and risk management, auditing). In the United Kingdom, the Banking Standard Board has been set up by seven big banks in response to the findings of a Parliamentary Commission. The Board aims to raise and spread behavioral standards inside the British financial system, thus contributing to the «continuous improvement in bank behavior and culture».

Box 2.4—“Using” culture

Although its influence on firm behavior has long been clear, culture has only recently been discovered as a dependent variable of planning by management literature. In theory, culture suited to the type of enterprise can make a significant contribution to firm success. This means that people “make use of” culture, that their behavior is inspired by company values, and that they have communicated company values to the market, emphasizing the positive aspects of its culture (Hofstede 1983). It is necessary for the “bosses” at all levels to continuously emphasize

the importance that behavior adheres to company culture, repeat and strengthen its basic contents and remind people that it has a positive impact on people and company performance.

The main changes since 2008 in the risk culture scenario are enforcement in legislation, growth of the risk function, introduction of balanced scorecards replacing sales staff performance indicators, shift in focus from compliance to conduct, and culture becoming a board issue (Cass Business School 2015).

So how can a renewed culture be fully developed and spread in a bank today?

Theory and cross-industry experiences clearly demonstrate that three mechanisms are critical for achieving the cultural transformation of the banking sector. (1) Changing the culture of a complex organization like a bank is possible, but difficult and requires the awareness of the need for change, many resources, and a long time. In fact, relationships between management actions and culture are not necessarily linear, as there are multiple, complex issues relating to proportionality and accountability of individuals versus institutions that require consideration by enforcement agencies (Group of Thirty 2015). A major improvement in culture can be secured by focusing on values and conduct, which are the building blocks of culture. (2) Change necessitates a systemic approach to all subjects involved, by taking into account their mutual roles. A sustained focus on conduct and culture shall be carried out by banks (board and management), and the banking industry. All is needed to make major improvements in culture within the banking industry and individual institutions (Group of Thirty 2015). Addressing cultural issues must of necessity be the responsibility of the board and management of firms. Supervisors and regulators cannot determine culture, but the former has an important monitoring function. (3) In order to be successful, the new culture has to be profitable and create real value for all subjects, institutions, and individuals which present forms on their own motivations explaining their possibly diverging behavior (Lo 2015). The effect of all this should be the creation of a competitive advantage for firms with better cultures and conducts, with respect to client reputation and the ability to attract staff

and investors. Banks will only succeed if they accept that culture is core to their business models and if they decide that fixing culture is key to their economic sustainability (Dickson 2015).

The assessment of a bank's risk culture and the perception of its possible distance from a culture that can be considered adequate to context, business model, and government requirements are matters for the individual bank according to its characteristics. In fact, there is no doubt that risk culture is widely inadequate today and that there is a need to move from "form to substance". The attitude "I have complied with the regulations" needs to be replaced by "I have done everything possible to prevent and resolve problems". Just because it is legal it does not mean that it is right (See Box 2.5).

Box 2.5—Measures to reduce misconduct risk

Codes and standards of conduct have been in place across the industry for some time. The issue was not the development of codes or standards, but their effective implementation and enforcement across diverse business lines and jurisdictions. Official sector and private sector representatives noted that the effective implementation of conduct risk management involves fundamental changes in culture and behavior across the industry, involving firms and market stakeholders. Such changes take time.

Critical implementation challenges include:

- Integration in business decision-making. The integration of behavior and ethical considerations in business decisions (which could involve limiting or withdrawing from certain transactions or businesses) challenges the "prevailing consensus" on success; other stakeholders, including a firm's customers and shareholders, may need to be involved in supporting these changes.
- Consistency of messages and action. The "tone at the top" is not always supported by consistent actions that demonstrate that conduct and ethical considerations visibly determine hiring, promotions, professional standing, and success. This requires coordinated engagement of all parts of the organization; ethical and behavior considerations cannot, therefore, be segregated into compliance or human resources functions. Ensuring that senior level employees take responsibility for driving forward changes is important to success.
- Cross-border and cross-cultural issues. Supervisors, clients, and stakeholders have different expectations and perspectives of the role of financial services providers. As such, approaches to conduct risk management, as well as rules relating to permissible incentives regarding conduct, differ across jurisdictions. These differences pose challenges

for global firms seeking to establish consistent expectations across the institution.

- Common taxonomy for conduct risk. The integration of conduct risk in all aspects of a firm's business, in a manner that is consistent across the industry, requires the development of a consistent set of definitions, methods of assessment, and measurement of conduct risk. These risks vary across product lines and may vary with the organizational structure of businesses within firms.
- Grey areas. Actions that are not "illegal" but which, under particular circumstances, could be inconsistent with a firm's values are sometimes difficult to address because they are often dependent on facts and circumstances. Frontline employees are often called upon to exercise their discretion in fulfilling customer requests; these decisions are sometimes complex and can vary across business lines. Under these circumstances, it is difficult to make prior determinations on the best course of action or to define clear boundaries. Firms need to develop frameworks to address these questions in a consistent manner. A visible institutional leadership in resolving and sanctioning a weak management of conduct risk will be important. Engaging business lines in cooperative approaches to identifying conduct risk such as "reporting in the public interest" may help overcome limitations of "whistleblowing" approaches, which risk putting employees and the institution on opposite sides. It was however noted that there was a significant amount of regulation and case law in existence which should help give firms clarity on what constituted a breach of regulation or law.
- Role of directors. While board oversight of conduct risk is critical to the strengthening of conduct risk management, an appropriate balance should be established between the accountability of individual executives and the board, in particular, NEDs. It was acknowledged that boards are facing increased pressure and that there may be a risk that this could potentially create disincentives for experienced and qualified experts to serve on them.

Source Adapted from Financial Stability Board (2015)

A process of cultural change is ambitious as it involves many players. It is the case that bank shareholders, management, bank staff, parliament, government, legal system, supervision authorities, media, education system, and customers are responsible for the current unsatisfactory situation to various degrees. What matters today is that all

these forces are involved in a common effort to promote a new banking culture shared by both banking authorities and clientele. And, importantly banks themselves shall play an active role in this new cultural change.

Risk culture is a sensitive area and cannot be dealt with on the single dimension of lowering risk propensity by strengthening supervision. The most fundamental issue in the risk culture debate is the trade-off between risk-taking and control (Power et al. 2013).

As reported in the Financial Times, the CEO of UBS recently commented that: “Mistakes are ok... try to eliminate all risk-taking and threaten to punish all mistakes and the ensuing culture of fear will limit the pursuit of legitimate business.” The controversy caused by these comments showed that seeking to completely eliminate risk, which after all underpins all financial intermediation, is unrealistic. Instilling into the personnel the fear of making mistakes can only lead to immobility. In the context of a robust and sound culture of risk, mistakes are a management tool and need to be explained in detail for a correct balance between risk-taking and the maintaining of an appropriate level of control. “Bad apples” in a bank shall not be allowed to take the blame for specific behavior which reflects a weak risk culture. Rather than a lack of personal integrity or a “natural” tendency towards dishonesty, non-compliant behavior is, in fact, the outcome of exogenous environmental and company factors which deform the sound conversion of individual values into behavior and actions, which, in other words, reflect a firm’s unsatisfactory risk culture. An experiment recently performed on a sample of bank managers compared with other sectors aiming to test their propensity to lie yielded interesting findings. The propensity to lie is similar in different sectors and in normal conditions, but rises significantly for managers, whose work environment (in this case the bank) is mentioned (Cohn et al. 2014).

Risk culture is definitively 100% compatible with risk-taking and profit-making. A sound risk culture helps ensure that activities beyond the institution’s risk appetite are recognized, assessed, escalated, and addressed in a timely manner (Dickson 2015).

2.6 Conclusions

Culture matters. Risk culture is essential for a prudent and sound bank management, and needs to be central in any evaluation. Risks are an inherent aspect of bank function and are taken, transformed, and managed with competence and professionalism. In this sense, risk culture is central to banks and has an impact on risk-taking propensity and policies, types of risk assessment/performance ratio and final decisions. The behavior of banks and their personnel are a direct expression of risk culture.

Banks must develop their risk culture beyond regulatory guidelines, in order to support their corporate strategy and strengthen their core skills, and turn risks into opportunities. They are required to commit, to more effectively improving their culture. The banks which are successful at doing this with consistency, awareness, and determination in strategic decisions will raise and consolidate their market reputation.

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2017, XXIX, 436 p. 47 illus., Hardcover

ISBN: 978-3-319-57591-9