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Response to Financial Stability Board consultation on Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: Consultative document

Paradigm Risk Consulting • London

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February 2014

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If we are uncritical we shall always find what we want: we shall look for, and find, confirmations, and we shall look away from, and not see, whatever might be dangerous to our pet theories. In this way it is only too easy to obtain what appears to be overwhelming evidence in favor of a theory which, if approached critically, would have been refuted.

Karl Popper, 1957, *The Poverty of Historicism*

About Paradigm Risk Consulting

We are a multi-disciplinary firm that combines excellence in analysis with penetrative insight in to the role of behaviour in the management of risk in the real world.

We are realistic about what works and what does not and we have the practical experience to judge. We won't waste your time with trendy, unproved ideas.

We are unapologetically a knowledge-based firm. Our advice is backed by extensive and on-going research and leading knowledge on risk and risk management in a firm setting.

We 'speak truth to power' so that you know that we will always give you an objective and informed opinion.

Our consulting work focuses on:

- Strategy, uncertainty and risk
- Risk & the enterprise, and
- Governance for performance

Recent published work relating to systemic risk and organizational culture includes:

- *Achieving supervisory control of systemic risk* (co-authored with PJ Di Giammarino), part-funded by the UK Government and published by the Financial Services Knowledge Transfer Network and
- *Regulation, risk & culture: will we never learn? The truth about Neil Armstrong, Barclays, LIBOR, risk & culture,* published by Paradigm Risk in 2012

These papers can be accessed at

www.paradigmrisk.com/publications

The Culture in Practice project

Paradigm Risk Consulting is currently leading a major review of organisational culture, including its influence on firms' management of risk, through an initiative called Culture in Practice. This project, which commenced in 2013, is a collaboration between Paradigm Risk Consulting, Futuresphere – a futures-oriented think tank – and Durham University Business School.

The project team has already reviewed extensively the academic and industry literature on organizational culture and risk culture and undertaken interviews of leading thinkers in the field of organizational culture, supplemented by workshops of practitioners.

An extensive programme of interviews and roundtables is scheduled for 2014. A final report is scheduled for Autumn 2014.

You can learn more about the project and interim documentation – including a detailed bibliography – at:

www.cultureinpractice.com

The risk culture bandwagon

In recent years, there have been several papers fetishizing risk culture. A selection includes:

- IIF report, 2009, Reform in the Financial Services Industry: Strengthening Practices for a More Stable System
- G30 Report, 2012, Toward effective governance of financial institutions,
- UK Parliamentary Commission on Banking Standards, 2013: Changing banking for good
- House of Commons Treasury Committee, August 2012, Fixing LIBOR: some preliminary findings
- An Independent Review of Barclays' Business Practices, April 2013: The Salz review
- Financial Services Authority Board Report, December 2011, The failure of the Royal Bank of Scotland
- UK Financial Reporting Council, November 2013, Risk Management, Internal Control and the Going Concern Basis of Accounting: Consultation on Draft Guidance to the Directors of Companies applying the UK Corporate Governance Code and associated changes to the Code
- The FSB consultation paper
- The UK Banking Standards Review by Sir Richard Lambert, February 2014

The frequency with which culture and 'risk culture' have been discussed by legislators and regulators of the financial services sector since the onset of the financial crisis indicates that it is a settled and well understood area of corporate discourse whose role in the financial crisis is uncontestable. It is not. The ideas in these papers are expressed with limited reference to the underlying technical literatures in culture – from anthropology, sociology, psychology, neuro-physiology, political science and organizational behaviour – and with, apparently, limited understanding of the dilemmas therein. However, they all share an assumption that culture can be used instrumentally within firms and that a firm's executives can create the culture they choose, if they are "sufficiently clear-eyed" and determined to do so.

This assumption, while convenient, is erroneous. In this response to the FSB consultation paper, we address the ways in which this assumption is erroneous and the implications of erroneous assumptions in the FSB and other papers.

Executive summary

It is understandable, even laudable, that FSB should wish to offer guidance to national supervisors on engaging with firms' cultures and how they relate to risk and risk-taking.

Culture is not within FSB's core skill set. It must be very careful to ensure that it accesses the knowledge and understanding it needs of culture to offer meaningful and constructive guidance.

Legislators and regulators of the financial services sector, like FSB, have relied heavily on the analysis of risk culture in the Institute for International Finance's (IIF's) 2009 paper. But on culture and risk culture, the IIF paper was neither well researched nor authoritative.

Culture is an issue of considerable complexity – a complex, emergent social phenomenon – which means that boards and executives cannot 'manage' it the way they may do other areas of the firm's business. Firms are complex systems; the outcome of behavioural interventions will be unpredictable.

FSB must take care – that is not, so far, evident – not to misdirect, even inadvertently, supervisors' attention only to those explicit elements of culture or contexts of risk behaviour they can witness and evidence. Supervisors will not be sufficiently trained observers of culture nor sufficiently value-neutral to observe a 'risk culture' objectively or to identify or understand implicit elements of culture.

Use of the term "indicators" to refer to artifacts of culture relating to risk is such a mis-direction. It implies a linear relationship that is subject to manipulation of performance.

Currently advocated approaches to compensation support only poorly the alignment of risk decision-making to shareholders' interests. Clawbacks and *malus* positions relating to corporate performance and subsequent institutional capital position are at odds with calls for alignment of accountability and risk recognition. EU bonus provisions are just odd; they are punitive and *dirigiste* and fail to align incentives to shareholders' interests or to encourage more sensible approaches to rewarding risk decision-making within the firm. They will increase aggregate risk in the financial system.

The formal elements of the firm's risk system – structure and formal specifications, analysis and espoused behaviours – and informal elements interact to influence behaviour. From the perspective of the firm as a system, both of the following are essential: (i) meaningful internal sanctions, and (ii) systems that appropriately estimate, price and allocate the cost of risk within the firm inter-temporally and across product lines to transaction level.

The presumption of efficacy of supervisory intervention in relation to culture or 'risk culture' rests on the sequence of reliability of observation and diagnosis through to reporting and prescription for action in the firm and the absence of unintended consequences. Supervisors should regard intervention in relation to specific behaviours or cultural elements as a 'nuclear option'.

In addition, we raise issues around the following areas:

- evaluating culture
- the focus on behaviour
- 'target' cultures
- failures of culture
- the importance of dissent
- alignment of incentives
- understanding culture

Issues in the FSB paper

It is understandable, even laudable, that FSB should wish to offer guidance to national supervisors on engaging with firms' cultures and how they relate to risk and risk-taking.

Since the global financial crisis, many commentators – official, academic, industry and public alike – have expressed concern at the 'risk culture' prevailing in financial institutions in the lead-up to that crisis. Few pause to consider what that means or how such perceived deficiencies may be remedied. Naturally enough, FSB recognizes its role in providing guidance to national supervisors on how their supervisory staff can and should effect more attentive supervision as it relates to the culture and to the 'risk culture' of the firms they supervise.

However, just because the assertion that culture is at the heart of the problems of the financial crisis is oft-repeated does not make it correct, nor does it mean that it is operable. The frequency of use (or misuse) of the term *culture* by commentators using it casually or metaphorically affords 'culture' a notoriety that may be beyond its utility. As Canadian academics Yvan Allaire and Mihaela Firsirotu pointed out in a seminal article on organizational culture in 1984,

> "this notoriety may turn a complex, difficult but seminal concept into a superficial fad, reduce it to an empty, if entertaining, catch-all construct explaining everything and nothing! Indeed, with a few notable exceptions, invocations of culture are not followed by any elaboration. It is presumed that the word 'culture' is a stenographic cue for 'values, norms, beliefs, customs' or any other such string of convenient identifiers chosen among the vast assortment of definitions available in a random pick of texts from cultural anthropology."[1]

FSB must be vigilant to ensure that it is using terms such as 'culture' and 'risk culture' carefully and appropriately rather than, in Allaire's and Firsirotu's term, a stenographic cue to something else.

Recent research by Michael Power of LSE and colleagues addresses this point directly. The authors described risk culture as a mix of formal and informal processes:

> "The former are easy to observe. The latter are harder to observe since they involve a myriad of small behaviours and habits which in the aggregate constitute the state of risk culture at any one point in time."

They went on to observe that organisations may have multiple risk cultures and that risk cultures may be "trans-organisational". As they point out, the discourse about risk culture is, in reality, often about something else:

> "The most fundamental issue at stake in the risk culture debate is an organisation's self-awareness of its balance between risk-taking and control. It is clear that many organisational actors prior to the financial crisis were either unaware of, or indifferent to, the actual trade-off or risk profile of the organisation as a whole. A combination of control functions being ignored or fragmented and of revenue-generating functions being given star status rendered the actual trade-offs involved in this balance institutionally invisible, both internally and externally, until disaster struck.
>
> "For this reason, the prescriptions arising from our research essentially point towards recovering the organisational capability to make visible, to understand, and to accept or change the actual control-risk trade-off."[2]

1. Allaire, Yvan and Mihaela Firsirotu, 1984. Theories of organizational culture, *Organization Studies*, 5: 193–226.
2. Power, Michael, Simon Ashby & Tommaso Palermo, 2013, Risk culture in financial organisations: a research report, LSE Centre for Analysis of Risk and Regulation, September

The authors conclude:

> "there is a need for financial organisations to be aware of the many trade-offs we have identified . . . to monitor these trade-offs, and to make explicit decisions about them where possible, rather than allowing them simply to happen to the organisation. When it comes to risk culture, our report suggests that it is not only the level of risk-taking that was deviant in many organisations. It was also the lack of this organisational self-knowledge and the authority to act upon it."

These are all valid areas for supervisory intervention. However, they lead to the conclusion that discussions of 'risk culture' are not really about culture at all. The authors suggest that discussions about risk culture are really discussions about self-awareness and making explicit the impact of behaviour on control of risk. If they are correct, firms would be better served by regulators recalibrating discussions to focus on what they mean rather than introducing the possibility – really, the probability – of confusion from an issue as complex and misunderstood as culture.

Culture is not within FSB's core skill set. It must be very careful to ensure that it accesses the knowledge and understanding it needs of culture to offer meaningful and constructive guidance.

In relation to organizational culture, John Kotter of Harvard Business School stated in an interview in Forbes in 2012:

> "Here is the problem: First, virtually no one clearly defines what they mean by 'culture', and when they do they usually get it wrong. Second, virtually no one has read the original research that shows why culture – when clearly defined – is so important, how it is formed, and how it changes."[3]

If FSB considers it necessary to comment on organizational culture and risk culture, it should at least ensure that it has "read the original research" In Kotter's words. Making quasi-regulatory pronouncements without having investigated and understood the breadth of research and complexity of the topic of culture appears reckless. It is apparent from the consultation paper that culture is not within FSB's natural skill set. There is no demonstration in the paper of familiarity with the academic or practical issues in understanding culture nor of the very real limitations these knowledge sets imply for the utility of intervention. Without such technical knowledge, the FSB must exercise considerable care in where it places reliance and the implications of its assertions.

The FSB states:

> "At the crux of this supervisory approach is an understanding, by both the financial institution and the supervisor of the institution's risk culture . . ."

Such an understanding is very difficult to achieve for either of those parties. The FSB goes on to state:

> "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 agreed risk appetite."

The introduction by FSB of the role of skepticism is apposite. However, the FSB does not, in its work, appear to adhere to its prescription for supervisors; FSB demonstrates a complete absence of skepticism in its review of the topics of culture and risk culture and has accepted, unquestioningly, profoundly simplistic analyses of a topic of essential complexity. In his essay The burden of skepticism, noted astro-physicist Carl Sagan stated:

> "It seems to me what is called for is an exquisite balance between two conflicting needs: the most skeptical scrutiny of all hypotheses that are served up to us and at the same time a great openness to new ideas. Obviously those two modes of thought are in some tension."[4]

In its consultation paper, FSB demonstrates only credulity in relation to previous commentaries on culture and risk culture. Such credulity is misplaced; the quality and validity of previous analysis of behavioural contributory factors to the global financial crisis varies enormously. In short, the FSB has relied too heavily in the formation of its expectations of supervisors on the prescriptions offering by the Institute for International Finance in 2009.

3. Kotter, John, 2012, The key to changing organizational culture, Leadership column, *Forbes*, 27 September

4. Sagan, Carl, 1987, The burden of skepticism, *Skeptical Inquirer*, 12 (1), Fall

Legislators and regulators of the financial services sector, like FSB, have relied heavily on the analysis of risk culture in the Institute for International Finance's (IIF's) 2009 paper. But on culture and risk culture, the IIF paper was neither well researched nor authoritative.

In its references in the consultation paper, FSB refers to the 2009 Institute for International Finance paper, *Reform in the Financial Services Industry: Strengthening Practices for a More Stable System*, Appendix 3 of which addressed risk culture. That paper appeared neither well-researched nor authoritative; yet, within regulatory circles, its assertions appear to have been accepted as gospel truths. That paper, in turn, relied heavily on earlier work by McKinsey & Co., which suffered from material methodological and inferential errors and extensive reliance on assumptions and assertions that were untested; it was not McKinsey's finest work.

Looking at several of the elements of the IIF paper is instructive. IIF states that 'risk culture' can be defined (a definition repeated by FSB) as:

> "the norms and traditions of 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."[5]

That is certainly a definition of risk culture; but there may be many more that are as valid or more valid than that offered by IIF. The difficulty is that there are several related concepts and metaphors at play in the simple phrase 'risk culture'. First, there is risk, which is, itself, not without contestable elements. Next, there is behavioural or human aspects of risk and risk management. Thirdly, there is the application to those aspects of the metaphor or analogy of culture and, fourthly, more strongly, there is the assertion that 'risk culture' is or may be a distinct or distinguishable subset or element of organizational culture more broadly.

Let us take the final of these points – risk culture as a distinct element of culture. The IIF definition offers a neat summation of one approach to culture reflected, to use IIF's own metaphor, through a risk prism. But there are many definitions of organizational culture and culture more broadly. Famously, in 1952, American anthropologists Alfred Kroeber and Clyde Kluckholn identified 164 different definitions of culture. It is unlikely the number of definitions has declined in the intervening sixty years. With so many different definitions available to choose from, which is the appropriate definition? With that question unresolved, the application of culture to the firm's management of risk is open to broad interpretation and may, equally, be open to presumption, misinterpretation and confusion, at least of terms.

Following its statement of definition of risk culture above, the IIF paper asserts:

> "Part of the management challenge of creating and sustaining a *strong risk culture* is to make explicit what is going on tacitly, to correct the negative aspects, and to enhance and entrench the strong aspects already in place." *(emphasis added)*

And yet, one of the leading analysts of organizational culture, on whose language the IIF paper appears to draw in parts, rejects explicitly the notion of a strong culture as identifiably good, noting:

> "It is very important to recognize that cultural strength may or may not be correlated with effectiveness. Through some current writers have argued that strength is desirable, it seems clear to me that the relationship is far more complex. The actual content of the culture and the degree to which its solutions fit the problems posed by the environment seem like critical variables here, not strength,"[6]

which Schein describes as homogeneity and stability of group membership and length and intensity of shared experiences of the group.

5. Institute of International Finance, 2009. *Reform in the financial services industry: Strengthening practices for a More Stable System*, The Report of the IIF Steering Committee on Implementation, IIF, December; see especially Appendix III.

6. Schein, Edgar, 1984, Coming to a new awareness of organizational culture, *Sloan Management Review*, 25 (2), Winter: 3–16

The IIF paper parenthetically references the important analysis of NASA in the review of the causes of the explosion of the space shuttle *Columbia*. Yet, the most important insights on culture therefrom are glossed over wholly; they are deeply relevant to FSB. In a discussion of the *Challenger* disaster, the *Columbia* Accident Investigation Board, one of the lead authors of the report of the *Columbia* Accident Investigation Board, Columbia University sociologist Diane Vaughan, wrote,

> "In the *Challenger* incident, the organization culture was much more complicated and its effects on decision-making more subtle and hard to detect than even insiders realized. As members of an organization, we are sensitive to certain aspects of culture, resisting it, but others become taken for granted, so that we unquestioningly follow its dictates without realizing what the culture is, how it is operating on us, or how we both use and contribute to it."[7]

This suggests that any effort by the board or by management to understand the firm's culture will be partial. Without clear attention to potential sources of partiality, supervisors will be similarly compromised. The IIF report goes on to examine overcoming such methodological problems:

> "firms have found that a "deep-interview" process with a reasonable sample of employees who are likely to have encountered risk issues is highly effective. Such processes are commonly conducted by specialists at consulting and law firms . . ."

although advanced training and experience in observational behavioural analysis is all too rare among the staff of such firms and such processes are not advocated nor even referred to in the FSB consultation paper. There is no reference in the FSB paper to the need for competence in behavioural analysis among supervisors nor of other behavioural disciplinary competence.

While there are many sound points in the IIF's 2009 paper, there are too many implicit assumptions in evidence for it to be considered authoritative on the topic of organisational culture or an element thereof. Extensive reliance on the earlier IIF paper weakens rather than strengthens the FSB consultation paper.

7. Vaughan, Diane, 1997, The trickle-down effect: Policy decisions, risky work and the *Challenger* tragedy, *California Management Review*, 39 (2), Winter: 80-102

Culture is an issue of considerable complexity – a complex, emergent social phenomenon – which means that boards and executives cannot 'manage' it the way they may do other areas of the firm's business. Firms are complex systems; the outcome of behavioural interventions will be unpredictable.

The language of the FSB paper implies that boards of directors or executives can 'set' or 'develop' a culture:

> "The board of directors and senior management are the starting point for setting the financial institution's core values and risk culture, and their behaviour must reflect the values being espoused. As such, the leadership of the institution should systematically develop, monitor, and assess the culture of the financial institution."

Management does shape culture but it does so unpredictably and in no way instrumentally; there are no cultural levers the firm or its executives can pull to create its desired cultural outcomes; perhaps *influences* would be a more apposite verb to use. Context also plays a vital role. To think that culture can be deployed instrumentally is simply to misunderstand the emergent character and complexities of culture and cultural analysis and to set up the firm for a plethora of unintended consequences of an ill-conceived cultural change programme.

FSB should be attuned to this point. One of the logics behind setting up FSB was to task an organization specifically to understand the complex network of interdependencies in the global financial system; FSB's work in this area has met with mixed success. Similarly, complexity impacts enormously on the possibilities for regulatory or managerial prescriptions of culture. But not all complexity is the same.

In his speech accepting the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel in December 1974, titled *The pretense of knowledge*, Friedrich von Hayek stated:

> ". . . the social sciences, like much of biology but unlike most fields of the physical sciences, have to deal with structures of **essential complexity**, i.e. with structures whose characteristic properties can be exhibited only by models made up of relatively large numbers of variables.
>
> "In some fields, particularly where problems of a similar kind arise in the physical sciences, the difficulties can be overcome by using, instead of specific information about the individual elements, data about the relative frequency, or the probability, of the occurrence of the various distinctive properties of the elements. But this is true only where we have to deal with . . . "**phenomena of unorganized complexity**," in contrast to those "**phenomena of organized complexity**" with which we have to deal in the social sciences. Organized complexity here means that the character of the structures showing it depends not only on the properties of the individual elements of which they are composed, and the relative frequency with which they occur, but also on the manner in which the individual elements are connected with each other."[8] *(emphasis added)*

For this reason alone, supervisors must demonstrate considerable caution in offering opinions on aspects of a firm's culture which they consider deficient; they will not have had the opportunity to observe all of the individual elements of which the system is composed. Offering partial opinions thereon to management will not improve supervisory credibility.

The IIF paper addresses this problem:

> In considering risk culture, some have tended to assume that it is too "soft" a concept for Boards and risk managers to work with affirmatively or, conversely, that it is too engrained in the nature and history of a given firm to be in any way malleable. A review of firms' experiences and of the literature showed clearly that both of these "fatalistic" responses to risk culture issues were erroneous, and a firm can change or develop its risk culture if it is sufficiently clear-eyed about the need to do so.

8. von Hayek, Friedrich, 1974. The Pretence of Knowledge, Prize Lecture: The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 1974, December 11

The review of firms' experiences, to which they refer, is not offered for comment; the literature to which they refer can only be that narrow section thereof, mainly from consulting practices, that supports assertions of managerial efficacy and has a clear commercial interest in doing so. Being "sufficiently clear-eyed" sounds like a recipe for hubris.

It is clear that culture and risk culture do not react linearly; that they are 'non-linear'. To quote the originator of chaos theory, Edward Lorenz:

> "In [non-linear] systems, the change in a variable at an initial time can lead to a change in the same or a different variable at a later time, that is not proportional to the change at the initial time."[9]

It is unlikely that being "sufficiently clear-eyed" will overcome such problems. Of course, that does not mean that sufficiently determined managers are unable to influence behaviour; the question is the unintended consequences such interventions may create. British/Canadian organizational theorist Gareth Morgan refers to these consequences:

> "To the extent that the insights of culture are used to create and Orwellian and world of "corporate newspeak", where culture controls rather than expresses human character, the metaphor may prove quite manipulative and totalitarian in its influence. The message: observer beware. There is often more to culture than meets the eye and our understanding is a usually much more fragmented and superficial than the reality itself. [However,] many management theorists view culture as a phenomenon with clearly defined attributes. Like organisational structure, culture is often reduced to a set of discrete variables such as values, beliefs, stories, norms, and rituals that can be documented and manipulated in an instrumental way."[10]

The discrete variables to which the FSB reduces risk culture will, no doubt, have an effect on the firm. But no one can be sure what that effect will be.

9. Lorenz, Edward, 1995, *The Essence of Chaos*, London: UCL Press

10. Morgan, Gareth, 1997. *Images of Organization*, Thousand Oaks, CA: Sage Publications

FSB must take care – that is not, so far, evident – not to mis-direct, even inadvertently, supervisors' attention only to those explicit elements of culture or contexts of risk behaviour they can witness and evidence. Supervisors will not be sufficiently trained observers of culture nor sufficiently value-neutral to observe a 'risk culture' objectively or to identify or understand implicit elements of culture.

The problem has long been identified. Kroeber and Kluckholn (they of the 164 definitions), for example, wrote in 1952:

> "The analysis of a culture must encompass both the explicit and the implicit. The explicit culture consists in those regularities in word and deed which may be generalized straight from the evidence of the ear or eye. The implicit culture, however, is an abstraction of the second order. Here the anthropologist infers least common denominators which seem, as it were, to underlie a multiplicity of cultural contents. Only in the most sophisticated and self-conscious of cultures will his attention be called directly to these by carriers of the culture, and then only in part."[11]

Without advanced training in and experience of behavioural analytic techniques, neither corporate officers nor supervisors can hope to assess culture meaningfully; the exhortation by the FSB to do so cannot contribute usefully to firms' management of risk. Also, relying on external advisors with a different and incompatible skill set will result in assessment routines that are bureacratised and ultimately meaningless that simply add cost and deflect worthwhile organic development of capabilities in firms.

Not all 'professional' contributions to the fields of risk and culture have deserved that epithet; most have been anything but professional. The Institute of Risk Management's 2012 paper on the topic[12] was riddled with error and supposition and (no-doubt accidental) mis-reading and mis-representation of earlier academic research. Neither that document nor the earlier IIF document is a sound basis for assuming that risk culture can meaningfully be assessed, least of all measured.

The fetish for quantification has, naturally, made its way to culture. Many advisors have advocated measurement of risk culture, including in the IRM publication. Most if not all make the heroic and wholly unsustainable assumption that individual psychometric instruments (which may be completely valid) are additive; they simply are not. Any prescription for change emerging from use of such instruments or 'target cultures' are likely to be fraught with unintended consequences.

As a complex, emergent social phenomenon, in culture and its impact on the context of risk behaviour, implicit elements of both the culture and the observer will impact the assessment. The artifacts or behaviours to which the supervisor pays attention will have a material impact on his or her assessment of a culture or 'risk culture'. Also, through *attention* we simultaneously reflect and impose values on the elements we observe, as psychiatrist and neuroscientist Iain McGilchrist explains:

> "Attention is not just another function alongside other cognitive functions . . . The kind of attention we bring to bear on the world changes the nature of the world we attend to, the very nature of the world in which those 'functions' would be carried out and in which 'things' would exist. Attention changes what kind of a thing comes in to being for us: in that way, it changes the world.
>
> "Through the direction and nature of our attention, we prove ourselves to be partners in creation, both of the world and of ourselves. In keeping with this, attention is inescapably bound up with value – unlike what we conceive as 'cognitive functions', which are neutral in this respect. Values enter through the way in which those functions are exercised: they can be used in different says for different purposes to different ends."[13]

11. Kroeber, A. L. and Clyde Kluckhohn, 1952. *Culture: A Critical Review of Concepts and Definitions*, Papers of The Peabody Museum Of American Archeology and Ethnology, Vol. XLVII, No. 1, Cambridge, MA: Harvard University

12. Hindson, Alex et al., 2012. Risk culture under the microscope, London: Institute for Risk Management, October

13. McGilchrist, Iain, 2009. *The Master and his Emissary: The Divided Brain and the Making of the Western World*, London: Yale University Press

Even the use of the term 'risk culture' – reflecting a metaphoric link to culture, enculturation and acculturation – as might a phrase such as 'risk politics', impacts how the supervisor will view the context of risk-related behaviour in the firm; the term itself structures attention and thus the values of observer and the observed:

> "Each of these metaphoric images *focuses attention in selective ways* and provides slightly different ways of knowing the phenomenon of organization. The use of a particular metaphor is often not a conscious choice, nor made explicit, but can be inferred from the way the subject of organization is approached, by discerning the underlying assumptions that are made about the subject."[13]

Viewed through such a lens, the exhortation to be "sufficiently clear-eyed" by IIF appears more than hubristic: it would seem to invite over-simplification and systematic distortion of what is being observed. That is not a suitable basis for supervisory intervention.

14. Smircich, Linda, 1983. Concepts of culture and organizational analysis, *Administrative Science Quarterly*, 28 (3), September: 339-358

Use of the term ‘indicators’ to refer to artifacts of culture relating to risk is such a mis-direction. It implies a linear relationship that is subject to manipulation of performance.

The use of the term *indicators* implies – though does not state – a relationship between the indicator and ‘risk culture performance’ that is essentially linear: the one drives the other. This is misleading and will reinforce supervisors’ misconceptions about the relationship between a firm’s culture, behaviour and the efficacy of the firm’s risk system.

In this context, FSB should adopt less value-laden terms; the technical term used in anthropology or organisational sociology is “artefact”; such a term is unlikely to appeal. Better terms may be ‘behaviours’, ‘elements’, ‘symbols and ‘signs’.

Providing a list of attributes or behaviours, elements, symbols and signs offers to supervisors the impression that these are comprehensive or the only behaviours or elements that are material. Providing such a list promotes, however inadvertently, a checklist approach to thinking about culture that is wholly inappropriate.

Currently advocated approaches to compensation support only poorly the alignment of risk decision-making to shareholders' interests. Clawbacks and *malus* positions relating to corporate performance and subsequent institutional capital position are at odds with calls for alignment of accountability and risk recognition. EU bonus provisions are just odd; they are punitive and *dirigiste* and fail to align incentives to shareholders' interests or to encourage more sensible approaches to rewarding risk decision-making within the firm. They will increase aggregate risk in the financial system.

The debate on compensation that has ensued since the onset of the global financial crisis following the housing bubble in 2006 – 07 and the collapse of Lehman Bros has been extraordinary. Despite the almost universal accord that remuneration structures contributed to excessive risk-taking in financial institutions and that excessive bonuses paid on anticipated accounting profit at the time of deal origination distorted decision-making and resulted in asymmetric risk-holding, almost nothing has changed.

The structures for addressing these problems are relatively simple. Yet they require several steps of imagination which, thus far, have been beyond policy makers and regulators in the EU and elsewhere. The EU legislation – the bonus provisions of CRD IV – are so far from a sensible solution that it is an embarrassment that the provisions made it from ECON on to the EU statute books. The provisions are punitive and *dirigiste*, fail to address the underlying risk profiles of risk-taker and risk-holder (or trader and shareholder) and, by forcing up base salaries or encouraging firms to shift risk-taking to arbitrage regulation, will increase rather than decrease risk in the financial system.

If the FSB is serious about addressing compensation provisions, it may wish to contribute to a research exercise in which we are participating with the think tank Futuresphere. More information is available at

www.futuresphere.net/current-projects

The formal elements of the firm's risk system – structure and formal specifications, analysis and espoused behaviours – and informal elements interact to influence behaviour. From the perspective of the firm as a system, both the following are essential: (i) meaningful internal sanctions, and (ii) systems that appropriately estimate, price and allocate the cost of risk within the firm intertemporally and across product lines to transaction level.

FSB identifies the importance of breaches of internal policies and risk limits. However, without a detailed and sophisticated funds transfer pricing system that recognizes the full risk cost of funds and capital required to support business activity which is reflected in assessment of performance, the firm cannot align performance reporting with economic contribution to the firm. Effective funds (and non-funds costs including operational risk) transfer pricing to transaction level is an invaluable behavioural tool in the firm.

Funds transfer pricing systems have routinely been in operation in banking firms since the 1980s. In that time, they have gradually incorporated more classes of risk and can now reflect accurately marked-to-mark pricing and modeled risk across most risk classes. The conditions and elements for effective funds transfer pricing were laid out in a letter in September 2010 from the then Director of the Risk Specialists Division at the UK Financial services Authority to Treasurers of relevant financial institutions. Other sources of guidance are also available.

By allowing the firm's funds transfer pricing system to price risk realistically at transaction level, the firm can send appropriately priced risk signals to the risk-taker or originating officer. These prices can and should also be used to reflect and reward performance. Such systems can and will have a material influence on risk-related behaviour in the firm.

The presumption of efficacy of supervisory intervention in relation to culture or 'risk culture' rests on the sequence of reliability of observation and diagnosis through to reporting and prescription for action in the firm and the absence of unintended consequences. Supervisors should regard intervention in relation to specific behaviours or cultural elements as a 'nuclear option'.

If managers face risks of unintended consequences in intervention in to culture and 'risk culture' and there are structural problems to supervisors' understanding of the firm's culture, combining the two appears compounds the improbability that supervisors will be able to intervene to address specific cultural 'problems' in the firm.

The presumption that supervisors will know pretty quickly what is a firm's culture is simply hubristic; the expectation that they will be able to prescribe an effective solution is more so. While specific behaviours are safer ground for intervention, firms are unlikely to respond to such intervention in the way the supervisor may desire; response internally is equally likely to be personalized and punitive as enlightened and effective.

This series of presumptions outlined in the FSB paper reinforces the impression that FSB has accepted 'hook, line and sinker' an idealized, instrumentalist view of culture and risk culture. Such presumptions are behaviourally naïve and will not encourage supervisory intervention that will result in improving risk-taking in the sector.

Specific issues in the text of the consultation paper

Evaluating culture

The paper states:

> Supervisors should also seek supporting evidence regarding how a firm systematically assesses risk culture including the processes used (e.g. employee surveys, independent reviews, internal reporting) and action plans to address findings on matters that may come to their attention.

Commentary

Despite extensive enthusiasm for them among practitioners, employee surveys provide little insight in to aspects of culture which relate more to the interactions between people. Individuals' opinions are not especially reliable predictors of their behaviour and are highly sensitive to instrument construction. Importantly, instruments that may be valid individually in relation to culture usually cannot meaningfully be aggregated to form a group picture. Internal reporting on aspects of culture that are not objectifiable are also unlikely to be useful.

FSB must take care to ensure that its guidance does not encourage supervisors to push firms to adopt approaches to assessment of culture that are methodologically dubious. The complex, emergent nature of culture means that it is usually most reliably assessed observationally. The multitude of instruments on the market can provide interesting time series data but are of limited utility instrumentally.

Focus on behaviour

The paper states:

> The board and senior management should proactively address behavioural issues and assess whether they are clearly and effectively articulating and monitoring the core values and expected behaviours toward risk.

Commentary

This prescription is considerably more operable than exhortations to focus on culture. Behaviours or actions are objectifiable and, often, verifiable making supervisory intervention more evidentially sound.

Target cultures

The paper states:

> The board and senior management have a clear view of the risk culture to which they aspire for the financial institution, systematically monitor and assess the prevailing risk culture and proactively address any identified areas of weakness or concern.

Commentary

While it fits with the instrumentalist view of culture as a management variable, 'target' cultures are not meaningful and, even if they were, extensive sociological analysis of organisations and management suggests they are not operable. Managers should focus on target and proscribed behaviours and interventions that can foster or inhibit such behaviours.

Failures of culture

The paper states:

> The board and senior management have processes in place to ensure that failures or near failures in risk culture, internal or external to the firm, are reviewed at all levels of the organisation and are seen as an opportunity to strengthen the financial institution's risk culture and make it more robust.

Commentary

It simply is not sensible to talk of a culture 'failing'. Cultures do not fail; they just are. People or groups or businesses fail; cultures may reinforce behaviours that contribute to failure but, assuming the group remains, the culture will persist and continue to adapt and evolve.

Importance of dissent

The paper states:

> Senior management has mechanisms in place to ensure that alternate views can be expressed in practice, and requests regular assessments of the openness to dissent at all layers of management involved in the decision-making process.

Commentary

Practically, the pressures to suppress dissent are strong in any group; the stronger the culture (more homogenous and stable), often the greater to suppression of dissent. Individual and collective "closed-mindedness" and "pressures to uniformity" in Janis' terms – Janis' type II & III symptoms of Groupthink – are prevalent in the corporate world. Within firms' risk systems, it is important, behaviourally, not only to recognize dissent but to acknowledge in major (and by extension, most) decisions that dissent is natural and ever-present; consensus is the exception rather than the rule. Far more corporate decisions should involve consideration and evaluation of competing viewpoints with recommendations rather than recommendations with supporting evidence only offered for decision-makers.

Importantly, also, information search is often mis-specified in a way that systematically suppresses dissent. Few decision-makers naturally seek disconfirmatory evidence of propositions (less that 10% by the standard, Wason test evaluation). This is as much a matter of decision competence as behaviour.

Alignment of incentives

The paper states:

> Remuneration and performance metrics consistently support and drive the desired risk-taking behaviours, risk appetite and risk culture of the financial institution, and encourage employees to act in the interest of the greater good of the company, rather than themselves or their business line.

Commentary

This statement highlights the behavioural dilemma faced in many firms: performance management systems have not been developed in such a way that the assessment of performance aligns between risk-taker, business line, firm and its shareholders. To do so – by far the most powerful expression of 'risk culture' – requires the firm to invest in effective funds and non-funds transfer pricing systems and performance management systems that operate to transaction and/or account level.

Understanding culture

The paper states:

> Understanding key risks and essential elements of risk management and the culture of the firm is considered a critical skill set for senior employees and reflected in development plans for employees.

Commentary

As we have outlined, it is an extremely difficult task to understand the culture of a firm, whether for a manager within the firm or a supervisor visiting the firm occasionally (or even frequently). Exhorting board members, executives or managers to do so is unrealistic. FSB should encourage those parties to consider the behavioural consequences of their risk routines and practices, reporting and performance management systems and interventions. Supervisors should seek to establish how the firm encourages its directors and executives to do so and how well they feel the routines they apply enable them to do so. Asking any more of directors, executives, managers or supervisors merely reflects a distorted, simplistic and instrumentalist understanding of culture that will not, ultimately be operable. Humility is the order of the day.

Paradigm Risk Consulting

Partner contacts

Board performance
Enterprise risk management

Peter Bonisch
e. peter.bonisch@paradigmrisk.com

Governance
CRO support

Dr Colin Johnston
e. colin.johnston@paradigmrisk.com

Technical analysis of risk
Decision support

Dr Mustafa Çavuş
e. mustafa.cavus@paradigmrisk.com

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Paradigm Risk Consulting Limited
L.5, 52-54 Gracechurch St
London EC3V 0EH

t. +44 20 7060 7475

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