Guidance on Supervisory Interaction with Financial Institutions on Risk Culture

Feedback on the FSB's Consultative Document[1]

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[1] The content of this document represents feedback from the three independent academics named above and does not necessarily reflect the opinion of our employers, project sponsors or project participants.

Introduction

We are grateful for the opportunity to comment on the Financial Stability Board's consultative document on the supervision of risk culture (dated 18th November 2013). The increased regulatory and practitioner attention on risk culture is testament to a growing awareness across the financial services sector that there is more to risk management than the development of statistical risk models or process driven ERM (Enterprise Risk Management) frameworks. We are reassured that financial institutions, and their regulators, are adopting a more balanced approach to risk management and hope that this will help to prevent future crises. However, we also have concerns about the direction of some of this work, including elements of the FSB's paper.

This response is drawn from our recent research project on: "Risk Culture in Financial Organisations"[2]. The primary aim of the project, extending over 18 months and involving several banks and insurers in the United Kingdom, was to discover and analyse how risk culture change management initiatives were taking shape inside different financial organisations. From this grounded and bottom-up point of view we decided not to define risk culture in advance but to observe and understand its manifestations within organisations (i.e. we explored what risk culture means to them, rather than compare it to some idealised model). This approach is close in spirit to the FSB's own statement at the bottom of page 1, regarding its unwillingness to define a 'good' or 'bad' risk culture. We interacted with personnel from the risk function, including a significant number of Chief Risk Officers (CROs), as well as some Chief Executive Officers, business function heads, and Audit and Compliance personnel; completing over 60 interviews, focus groups and workshop sessions. We supplemented this interview-based approach with a formal survey of relevant CII (Chartered Insurance Institute) and CIMA (Chartered Institute of Management Accountants) members and engaged, for comparative purposes, with personnel from two non-financial companies – an airline and a large industrial company. Interviews with a number of regulators and advisory firms (consultants) were also conducted.

Naturally, we are proud of our research and commend the full report to FSB. We think that the findings of our project have implications for the supervision of risk culture across financial organisations. Notably our project challenges some of the increasingly common misconceptions that have been applied to the concept of risk culture, misconceptions that the FSB is in danger of reinforcing with elements of the consultative document.

If we are to improve the management of financial organisations and hopefully prevent future financial crises, as well as damaging events such as the LIBOR scandal, it is vital that the regulation, supervision and management of risk culture are based on robust and unbiased foundations. Our research does not have all the answers and raises further questions which practitioners, regulators and academics must consider. Nevertheless it does highlight some potential 'blind alleys' and destructive pathways that the FSB should avoid. It also provides

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[2] See: Power, M, Ashby, S and Palermo, T (2013) *Risk Culture in Financial Organisations: Final Report*, Financial Services Knowledge Transfer Network, London, www.lse.ac.uk/researchAndExpertise/units/CARR/pdf/Final-Risk-Culture-Report.pdf

some further directions that the FSB should consider in the development of its risk culture work.

Drawing on our research project we offer feedback to the consultative document structured around the following themes:

1. The unintended consequences of regulating risk culture
2. Conceptualising risk culture
3. The plurality of risk culture and risk culture trade-offs
4. The FSBs facets of risk culture: tone, accountability, challenge and incentives
5. Beating the trans-organisational regulatory culture: taking risk culture beyond governance and internal control
6. Abstract versus concrete questions to ask about risk culture in financial organisations
7. Supervision and supervisory cultures

Theme 1: The unintended consequences of regulating risk culture

Regulators and their supervisors have an important role to play in any financial system, helping to preserve financial stability and protect vulnerable stakeholder groups. However poorly designed regulatory and supervisory initiatives can have destructive consequences, weakening the very stability that they are trying to preserve.

This risk is especially acute in emerging areas like risk culture, where a common understanding of the concept is yet to emerge. In particular there is a very real danger that regulators/supervisors 'push' financial organisations into cultural stereotypes and management approaches that are not consistent with their current risk culture. As we will explain under theme 3 below there is significant plurality in terms of current approaches to managing risk culture, with many difficult trade-offs to consider. What works for one financial organisation, may not work for another, even if they may superficially appear to be similar. There are only limited gestures towards this variability in the FSB's guidance; which is in danger of being overly monotone (one dimensional) in approach.

Pushing financial organisations into particular cultural stereotypes/approaches can cause significant dissonance and may distract these organisations from what they believe to be more important risk management priorities. The FSB's guidance is also silent on potential regulatory impacts on risk culture. We have found evidence that the risk cultures of financial organisations are not independent of regulatory or supervisory style, with the 'tone' at the regulatory-firm interface being particularly influential on the risk cultures and associated management practices of some organisations; influences which are not always welcome, or desirable and which can change the dynamic of what these organisations would do naturally.

We observed a sizable group of 'frustrated' organisations (see Power, Ashby and Palermo 2013, Ch. 8) who were often negative about the effects of regulation/supervision and in particular the regulatory demands for documentation concerned with trying to make soft factors (like risk culture) visible and measurable. Risk culture may be tracked and measured in visible ways, but the very instruments which exist to do this (e.g. staff surveys and other tools), provide only indirect observations of behaviour at best. In one organisation we heard that they were comfortable that their risk culture was ‘good’, but that they had difficulty demonstrating this to supervisors, especially for areas of their business which tended to be highly ‘action-oriented’.

Other frustrations were as follows:

- Pressures for increased levels of documentation in organisations that have functioned perfectly well without such documentation in the past. The process of writing things down has its own potentially negative effects; academic research suggests that behaviours can be ‘crowded out’ by the need to create audit trails (Power, 2013). Here some organisations observed that regulation was directly influencing business decisions and was at times leading to excessive degrees of risk aversion – with profits, as well as the supply of financial services products, suffering as a result. It was also commented to us that these pressures for documentation, which appeared to be of very limited benefit to either financial organisations or their regulators, were ‘bureaucracy gone mad’, creating significant resource pressures on staff that were destroying the value focused risk cultures they already had (and were comfortable with).
- A paradox of formalisation, created by regulation. In a context of increased regulatory pressure ‘form’ can sometimes dominate ‘substance’, creating a trade-off between documenting things for regulatory purposes only and writing things down to make sure that organisational actors debate what they think they should debate. In the worst examples of this it was observed that one financial organisation may appear to have a “worse” risk culture than another, but in reality the latter is simply better able to document what they are doing, thus appearing ‘stronger’.
- Barriers to innovation and alternative perspectives on risk management. For example, certain insurers noted, with significant amusement, that in some regimes they had been under significant pressure to adopt VaR-type risk models prior to the financial crisis (as many banks had already done) and yet such models did little to help banks manage the effects of the crisis. It was also noted that regulators/supervisors were sceptical of alternative approaches to risk governance, preferring instead for firms to adopt a rigid three lines of defence approach – despite some potentially significant limitations with this approach (see theme 4 below).

This does not mean that regulators/supervisors should completely avoid monitoring or trying to influence the risk cultures of financial institutions. We found that some financial organisations were happy to co-operate with regulators/supervisors and that the approaches to managing risk culture adopted by these co-operators were much more consistent with the position outlined by the FSB’s consultative document (a finding that often applied to the banks in our research, but not the insurers). Moreover, we support the FSB’s apparent openness in relation to the types of methods and evidence that may be used to help assess risk culture (e.g. including employee surveys and other approaches that are not necessarily linked to formal risk management and compliance processes).

However, while the FSB stresses the need for supervisors to have discussions with management, and emphasises that evidence should be broadly based to avoid a compliance driven exercise (p.4), there is little sensitivity to the risks of the regulatory culture itself and its evidentiary style based in audit trails. Furthermore, a regulatory/supervisory approach which is only consistent with a proportion of financial organisations, and potentially not even the majority, is questionable. Incompatibilities between the views of certain financial organisations on managing risk culture and those of their regulators/supervisors, does not mean that regulators/supervisors are 'right' and these organisations are 'wrong' – as the FSB notes it is difficult to distinguish between 'good and bad' risk cultures. In terms of our findings it can be equally difficult to distinguish between risk cultures that are being managed in a sound fashion and those that are not. Themes 2 and 3 below explore this further.

Theme 2: Conceptualising risk culture

We have observed that much of the debate concerning risk culture, by regulators, practitioners and advisory organisations alike, is dominated by a more or less explicit precautionary perspective on risk culture; the notion being that a prudent (risk averse) and highly controlled risk culture is somehow superior. We have found that while this may be one potential perspective in the discourse on risk culture, it is at odds with a fundamental reality within commercial organisations – that risk taking is an essential part of their success. Without risk there can be no reward – especially within financial services, where financial organisations are in the business of taking risk, and directly support our capitalist economies as a result (there would be no lending activity, insurance, etc. without risk taking).

A further problem with this prudent/high control model of risk culture is that it is based on the premise that people/organisation are self-interested and inherently motivated to 'do wrong'. While recent events such as the financial crisis or the LIBOR scandal indicate that bad behaviour can and does happen in certain organisational pockets, there is no compelling evidence that this is valid for the majority of people within financial organisations. Indeed our research suggests the opposite. As a result a regulatory infrastructure based on the premise of prudence and high levels of control may only serve to add a further source of frustration within many well intentioned financial organisations.

To reflect these realities we feel that a more symmetric view of risk taking and control is appropriate when conceptualising risk culture. In essence taking too little risk can be as damaging as taking too much. Where excessively prudent and highly controlled financial organisations are unlikely to generate sufficient revenues to enable them to grow, or potentially even cover their costs. We develop our perspective on this further in Chapter 2 of our report (Power, Ashby and Palermo, 2013).

Regulators and supervisors may of course prefer high levels of prudence and control, even if this leads to the eventual demise of some financial organisations. A slow death resulting from low levels of risk taking and associated minimal growth is unlikely to concern regulators as much as a high risk taking organisation that fails suddenly, not least because there is plenty of time for low risk organisations to either wind down their business or seek a merger. However such stagnation is not necessarily good for our economies as a whole, where high levels of risk taking may well be preferable at times, providing the rewards are sufficient.

It is a key misconception of the financial crisis that high levels of risk taking per-se were at fault. Rather the issue was more one of organisations taking high levels of risk, without generating significant levels of reward to compensate for this, in short an “impoverished conception of risk appetite” (see Power, 2009). High levels of risk taking are nothing to be feared, providing the returns are sufficient.

To counteract what we regard as the ‘prudence drag’ on the risk culture debate, we think that it would be helpful and honest if the FSB could provide a model of a financial organisation that was aggressive in risk-taking terms but had a sound risk culture, as defined by the various indicators in the document. Such an organisation would be explicit about its values, monitor them via clear accountabilities and would have a well-defined risk appetite understood by employees, regulators and shareholders. It may well be that society would not wish such an organisation to exist in this form, but then at least the issue is clear. It is not one of bad risk culture as such. It is because the risk appetite of society, as expressed by the regulator, is different from that of the board of directors of the financial organisation.

This example suggests to us that the key focus for regulators and supervisors on risk culture, should not, therefore, be the promotion of increased levels of prudence and control across all financial organisations, but rather to foster a better appreciation within some financial organisations of the balance that needs to be maintained between risk and return (i.e. to improve their understanding of how to determine an appropriate appetite for risk). Organisations that take risk without fully appreciating either the consequences or the returns required to cover these risks are the ‘problem’, not those who are already making informed risk management decisions which achieve an appropriate balance between risk and return. Ensuring that management are capable of understanding the trade-offs between risk taking and risk control should also be a priority. Indeed, our research suggests that the ability to understand genuinely this trade-off is an important risk culture indicator.

Theme 3: The plurality of risk culture and risk culture trade-offs

We strongly support the FSB’s assertion that there is no clear distinction between a good or bad culture and would agree that risk culture is a multi-faceted concept, though we do not necessary agree that the FSB’s 4 facets (tone, accountability, challenge and incentives) are the ones worthy of the most focus.

What we have found in the course of our research is that risk culture work within financial organisations is characterised by two interrelated factors:

- A high degree of plurality. What works for one organisation, is not necessarily the same for another – even if they share a similar business model.

- Multiple trade-offs, with financial institutions having to balance often competing objectives (e.g. production versus protection, risk taking versus control, risk functions as partners or overseers, etc.).

The implications of this for the FSB are that, at the current time, it is not even possible to clarify the elements of a 'soundly' managed risk culture, let alone the characteristics of strong or weak risk cultures. Moreover our research provides a somewhat different view of the 'facets' which are worthy of focus when investigating the risk cultures of financial organisations (Power, Ashby and Palermo, Ch. 3). Notably there is a danger that the FSB is over-focusing on the visible spectrum of risk culture within financial organisations, which only represents the tip of the iceberg. Much of risk culture is unseen and implicit and relates to personal relations and nebulous aspects like trust.

We provide a critique of the FSB's 4 facets in our next theme (theme 4).

Theme 4: Examining the FSB's facets of risk culture

Here we compare the FSB's facets of risk culture with the findings from our research. We do not intend to denigrate the FSB's work on these facets, which represents an important step forward in the regulatory analysis of risk culture. However we would recommend a significant reformulation of these facets, coupled with a more balanced view of what constitutes a 'sound' approach to risk culture within financial organisations.

Tone from the Top

The significance of 'tone from the top' is a common theme in risk culture work and we would agree that it can be important. However, it has become a kind of mantra and there is a danger of over-stating its role and importance. While the importance of 'tone' may have its roots in a popular branch of the more general academic literature on organisational culture (Schein, 2010), it is at odds with more human-organic orientations towards culture, that are much less hierarchical in orientation (for example, Weick and Sutcliffe, 2007). Hence not all scholars share the view that a clear 'tone from the top' is important. Indeed our own research is not conclusive on this point, with relatively few of the people/organisations we spoke with raising 'tone' as an explicit issue, since it is so metaphorical. However, there was much discussion about top-down structural changes, such as the creation of new risk oversight units, which can be taken as a more tangible manifestation of 'tone' (tone in the form of actions, rather than words). Hence, tone is – as your collection of indicators suggests – a code for many different things. For example, we agree that talent development is important in organisations for many reasons but it is a noisy indicator at best of 'tone from the top'. So, further research of this variety is needed before 'tone from the top' can be confirmed as a key element of a well-managed risk culture.

The FSB should also reflect further on the constituents of an appropriate 'tone'. We do not agree that an appropriate tone should necessarily be one of prudence or that it should promote a high level centralised control (see theme 2 above). Neither do we agree that formal assessment tools are always required to support the development of an appropriate tone. Indeed the whole idea that top management should try to mould the risk culture of their organisation towards some idealised conception of it (developed by themselves and or their supervisors) is highly suspect and at odds with the evolutionary nature of most organisational cultures, including risk cultures.

Despite our reservations many financial organisations are already trying to mould their risk cultures towards some idealised ‘type’. One of the most significant trends we observed during the course of our research is a ‘swing to centralisation’, with many financial organisations devoting significant resources to increase the level of central control, both via structural change and enhanced risk information flows. This has included increased emphasis on the three lines of defence approach, as well as the creation of risk oversight functions.

However our research suggests that this trend may not be optimal for all financial organisations. Notably some of the organisations that we spoke with highlighted significant weaknesses with the three lines of defence approach and in particular the risk oversight role which is assigned to the ‘independent’ risk function. Restricting the role of the risk function to one of oversight can distance this function from business line management and affect their ability to interact effectively. The more independent a risk function is, the less involved risk staff often get in first hand business decision making. This can reduce their ability to influence decision making at an early stage and can also lead to mistrust between business line and risk staff. Many of the risk managers we spoke with commented that the more they worked in partnership with the business the more open business management became with them. Business line management were often also more open to helpful suggestions from risk colleagues that worked in partnership with them – helping them to make better business decisions.

Of course there is a common view that close relationships between business line management and the risk function can lead to the ‘capture’ of risk staff, who may, if they get too close to business decision makers, ‘go native’ and fail to exercise sufficient challenge. However, this argument rests on the assumption that staff from different areas of the business will necessarily behave in a self-interested way, putting their own personal (or local group) interests before those of the organisation and its stakeholders. This assumption is itself a cultural phenomenon and we were interested to learn that such a self-interested view is not shared in the airline industry – where there is an exceptionally close partnership relationship between business line ‘management’ (e.g. pilots, engineers, etc.) and airline safety staff – both ‘groups’ recognising that they have a shared responsibility to maintain high levels of airplane safety for the benefit of their organisation and its stakeholders. Perhaps therefore the trend towards increased oversight and role demarcation is a symptom of a specific type of ‘low trust’ risk culture, rather than a top-down solution to the ‘problems’ of risk culture within financial organisations. In short, the FSB should be suggesting to supervisors that the three lines of defence model is a rough template for thinking about the organisation of control functions, and not a rigid standard.

Finally we would challenge the notion that a clear, universal ‘tone from the top’ coupled with strong central control is optimal for all organisations. Again we found organisations that functioned equally well with less rigid structures and often quite dispersed risk-sub cultures. This again comes back to our theme above (theme 3), where we found a high degree of plurality of practice. Some organisations are quite comfortable with having very different risk sub-cultures, as these cultures reflect either national differences or differences in markets/risk appetite. Indeed it would seem to us that it is how these risk sub-cultures are managed that is the issue – providing organisations are able to keep these cultures within an acceptable ‘bandwidth’ in terms of risk taking and control then all should be well. It is only when this bandwidth is exceeded that problems occur (as arguably in the case of Barclays). It is also interesting to note that, even in organisations with high levels of central control and low levels of sub-culture bandwidth, problems can occur – as in the case of HBOS in the UK (Parliamentary Commission, 2013).

Accountability

We agree that accountability can be a factor in risk culture. In our own research, for example, the importance of a ‘just’ culture was highlighted, where individuals are held responsible for their own actions, but are not blamed for ‘innocent’ mistakes or errors. Neither are they ‘blamed’ for adverse outcomes when they did all that could reasonably be expected to make the ‘right’ decision (i.e. simple bad luck).

However this facet goes much deeper than accountability. Indeed there is a danger that focusing too much on accountability may reinforce the misconception that all organisational actors are self-interested and that high levels of control, coupled with highly demarcated governance frameworks like the three lines of defence approach, are an essential element of a sound risk culture, when we have found that they are not. In some organisations lines of accountability can be very successfully blurred from time to time, allowing risk functions to more closely partner with business decision makers for example (see our comments under ‘tone from the top’ above).

From our research we identified that generating a respect for risk taking and control is much more important than trying to enforce accountability for risk taking and control decisions. Making key organisational actors responsible for certain risk taking and control objectives does not necessarily mean that they buy into these objectives. In contrast developing a respect for these objectives will ensure that these actors not only make the ‘right’ decisions, but accept the rationale for making these decisions.

Effective Challenge

Again we believe that this facet runs deeper than suggested by the FSB. Although challenge may well be an important part of human interaction, our research suggests it is not the only interactive factor that can influence the risk cultures of financial organisations.

A key trade-off identified in our research related to the influence that networks and interaction can have on the risk cultures of financial organisations. Here we contrast what we term ‘touch point enthusiasts’ with ‘touch point realists’.

In the touch-point enthusiasts were observed a strong desire for close/regular face-to-face communication across all management lines, functions and levels (i.e. all relevant touch-points), including business lines and the risk function, with an equal emphasis on formal and informal methods of communication (e.g. water cooler conversations) to build up high levels of cross-functional consensus and trust. Once again such close relations may contravene functional independence, but they do not necessarily threaten the authority of the risk function. In such environments risk function staff were often able to be more involved in both operational and strategic decision making, helping to add a risk perspective to these decisions at the very start.

Touch point realists correspond more to the FSB’s current view. Such organisations were sceptical of overly close interaction, either because it can slow decision making (e.g. via too strong a desire for consensus), or because it can prevent clear accountability for decisions or impede independent risk oversight (with risk functions ‘going native’). However that did not mean that they were anti-interaction or that they saw the interactive role of their risk functions as being simply limited to exercising challenge.

We would therefore recommend that the FSB deepens it focus to consider a wider conception of interaction within financial organisations. Not all interaction between business line management and risk functions needs to involve challenge. Moreover, even to the extent that challenge may be required from time to time, the FSB should develop a more sophisticated view of challenge – in which challenge is periodic but not constant. It is another trade-off that financial organisations must grapple with – challenge can be necessary, but exercising too much challenge can unnecessarily slow down decision making and potentially destroy trust between business line managers and the risk function.

Incentives

Based on our research findings we would agree that incentives can influence the risk cultures of financial organisations, and vice-versa. However, this relationship is not strong in all financial organisations, so there is a danger of being too prescriptive about what supervisors might expect to see around the design and implementation of ‘risk culture appropriate’ incentive arrangements.

We found that both ethics and incentives can be used as mechanisms for behavioural change and that organisations which emphasised the ethical end of this continuum did not necessarily need to rely on formal incentives. For example, in some financial organisations (especially the mutual sector) we have found that there can be a strong sense of community and organisational loyalty (e.g. bank branches embedded in local communities) which can help to create deep underlying assumptions (e.g. of openness and respect for risk and control) which support effective risk taking and control without the need for incentives or other formal control mechanisms. We also found that staff in such organisations valued less financial rewards – such as a less pressured, family orientated work environment or greater job security.

On incentives we found that they can work as a positive force for promoting behavioural change, but that there may be limits to this effectiveness – especially in relation to supporting longer term goals (performance plans beyond 5 years). So even where incentives are relied upon they are not a perfect substitute for softer (social) mechanisms of aligning staff with the long term goals of an organisation. In essence incentives may provide a 'quick fix' but not enduring change. Moreover, excessively heavy reliance on formal incentive mechanisms to promote risk culture change can be symptomatic of an organisation characterised by self-interest and low levels of trust and there is evidence to suggest that an excessive reliance on incentives may help to further promote self-interest and dull creativity (see Salz, 2013, Appendix B).

Theme 5: Beating the trans-organisational regulatory culture: taking risk culture beyond governance and internal control

As we noted in theme 2 above risk culture is as much about risk taking as it is about promoting effective corporate governance or internal control. We would strongly encourage the FSB to reflect this reality in their work on risk culture.

In the course of our research we observed a potential barrier to the development of a more balanced (risk taking and control) perspective on risk culture: the presence of a trans-organisational regulatory culture that is rooted in some deep-seated views about what good governance and internal control should be about (e.g. prudent, control orientated, a focus on formal assessment, pro-active risk culture management, etc.).

Although we do not have definitive proof of a trans-organisational culture, we have observed that there appears to be a strong degree of overlap between front line supervisors within regulators; advisors with control and compliance backgrounds; and some risk management staff within organisations – whereby such individuals work closely together, share common values and often move between roles in these three areas. This inner-circle of risk and audit professionals seem to have created a shared view of what risk culture is, as well as a common language about risk; but it is also in danger of creating an overly pessimistic and mechanistic view of risk, which views risk as 'bad' and in need of significant simplification and control via formalised metrics. We suspect that this trans-organisational culture is very powerful in shaping thinking, but it is deeply inconsistent with a more enterprising and entrepreneurial view of risk – where risk taking is necessary to generate reward. It is also out of line with culturally-based forms of risk management in 'high reliability organisations' (e.g. Weick and Sutcliffe, 2007), which are able to achieve high levels of organisational resilience in inherently risky environments through the use of softer management techniques and a reluctance to simplify risk and uncertainty.

In our review of risk culture practice (Power, Ashby and Palermo, 2013, Appendix C) we explore practitioner, regulatory and advisor views on risk culture in more detail. In particular, we would note that advisory (consulting) organisations have been a key driver in the current thinking on risk culture, a development that has a number of strengths and weaknesses. An important issue is the audit based perspective toward risk culture adopted by most advisory organisations – their apparent aim being to make risk culture into a thing that can be measured, controlled and moulded towards some management ideal. To date there is no clear evidence that such a perspective works, at least for all financial organisations. We noted in our interviews with some financial organisations that they were sceptical of the risk culture 'products' offered by advisory organisations, though others were more enthusiastic (Power, Ashby and Palermo, 2013, Chapter 7).

Finally we observed a degree of frustration on the part of advisory organisations, with some admitting that they were finding it hard to market the 'fluffier' elements of risk culture. We were also told that regulatory desires to make risk culture 'tangible' were affecting the nature of the products being offered. Though, on a more positive note, we observed that some advisory organisations are trying to develop enhanced risk culture tools that better reflect the human-behavioural aspects of risk culture. Often these were being developed with HR specialists within their advisory practices.

Theme 6: Abstract versus concrete questions to ask about risk culture in financial organisations

We understand the desire that regulatory, advisory and some financial organisations have to make risk culture amenable to more effective monitoring. Our own research was in part stimulated by this desire. However to the limited extent which risk culture can be monitored via surveys and metrics, we recommend that the FSB considers the difference between what might be termed 'abstract' versus 'concrete' questions.[3]

In our review of the various indicators that have been proposed by the FSB we were struck by the relatively abstract nature of many of the questions/statements that were presented. Abstract questions are questions that can be answered without any substantial evidence and hence can be easily circumvented. They may also be linked to generic notions of management – such as the elements of a strong risk management framework – rather than the specific topic at hand (i.e. risk culture in this context).

The very first statement under 'tone from the top' (3.1.1) is a good example of an abstract question. It is easy for senior management to state their commitment to establishing an effective risk appetite statement and even supply documentation that illustrates this – but how can such a commitment be shown to be fully embedded as a core belief/assumption?

Of course it is not easy to find effective questions/statements that can indicate a 'well-managed' or 'strong' risk culture, to the extent that this is even possible. However one way

[3] See Power (2011).

for the FSB to improve the quality of its guidance would be to develop more ‘concrete’ questions/statements.

Concrete questions are specific (i.e. they are directly related to risk culture) and are difficult to answer in a vague or circumstantial way. In our work we propose a number of such questions/statements for the senior management of financial organisations, in the form of a series of challenges. It would be relatively easy to develop these challenges into some more meaningful metrics on risk culture in financial organisations, though we would again stress that this picture is never, given what we know/don’t know about risk culture, going to be complete.

The full list of concrete questions that we provide is contained within the Executive Summary of our report; some examples are as follows:

- How do you consciously translate risk appetite issues into a language which business units can understand and own?
- How do you get assurance that the risk function is focused primarily on supporting business decisions?
- When risk limits and tolerances are changed, is the risk function a leader or a follower in the decision?
- Do you push back and challenge the regulator? If not do you know why not?

Theme 7: Supervision and supervisory culture

The final theme that we wish to highlight in our response to the FSB’s consultative document relates to the ability of supervisors to supervise risk culture.

As the complexity of financial services regulation increases so do the demands on supervisors. However while there are some excellent supervisors across many national and international regulatory agencies, the limited supply of these individuals, coupled with the desire for a degree of standardisation in approach, will almost inevitably mean a metric driven approach to the supervision of risk culture.

We believe that there are significant dangers in such an approach. As should be clear from our response and our research, risk culture is a highly complex phenomenon, and while surveys, metrics, etc. may help to shed some light on the more superficial elements of risk culture they will never reveal its true depth. To understand the true depth of a risk culture requires significant time and risk management knowledge/experience, commodities that are often rare; especially in stretched supervisory teams who have to cope with a wide range of issues/topics.

We would also reiterate our findings regarding a potential trans-organisational culture between regulators, advisors and risk management staff within financial organisations. The existence of such a culture challenges the independence of supervisors, especially more junior ones, who are likely to be considering a move from regulation/supervision to higher paid industry based careers.

In the light of these reservations we would recommend that the FSB, along with other relevant agencies, provide more detail on the practicalities of supervising risk cultures. How can international regulators guarantee that risk culture will be supervised in an effective way across all supervisory agencies?

Conclusions

Regulators are right to consider risk culture; especially after years of almost exclusively focusing their efforts of risk models and capital adequacy regimes which have hardly distinguished themselves, either during the global financial crisis or subsequently (e.g. as in the JP Morgan 'London Whale' case). However whether inherently soft concepts such as risk culture can or should be an explicit supervisory concern needs much more debate. The current fashion for 'risk culture' may be as much a symptom of the problems we face as the cure.

Even to the extent that risk culture can/should be supervised we believe that the FSB must reconsider its current overly narrow view. Instead the FSB must do more to reflect the plurality of the concept and the significant trade-offs that are being managed by different financial organisations which are grappling with a range of risk culture work streams and initiatives.

Our work, as independent academics, provides a starting point for this reformulation and we would be happy to discuss our views further with the FSB. Given the significant and potentially destructive influence that supervisors can have on the risk cultures of financial organisations it is vital that the FSB and its partner agencies positions this guidance document in as sensitive a way as possible, before promoting greater supervisory attention and intervention on the risk cultures of financial organisations.

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