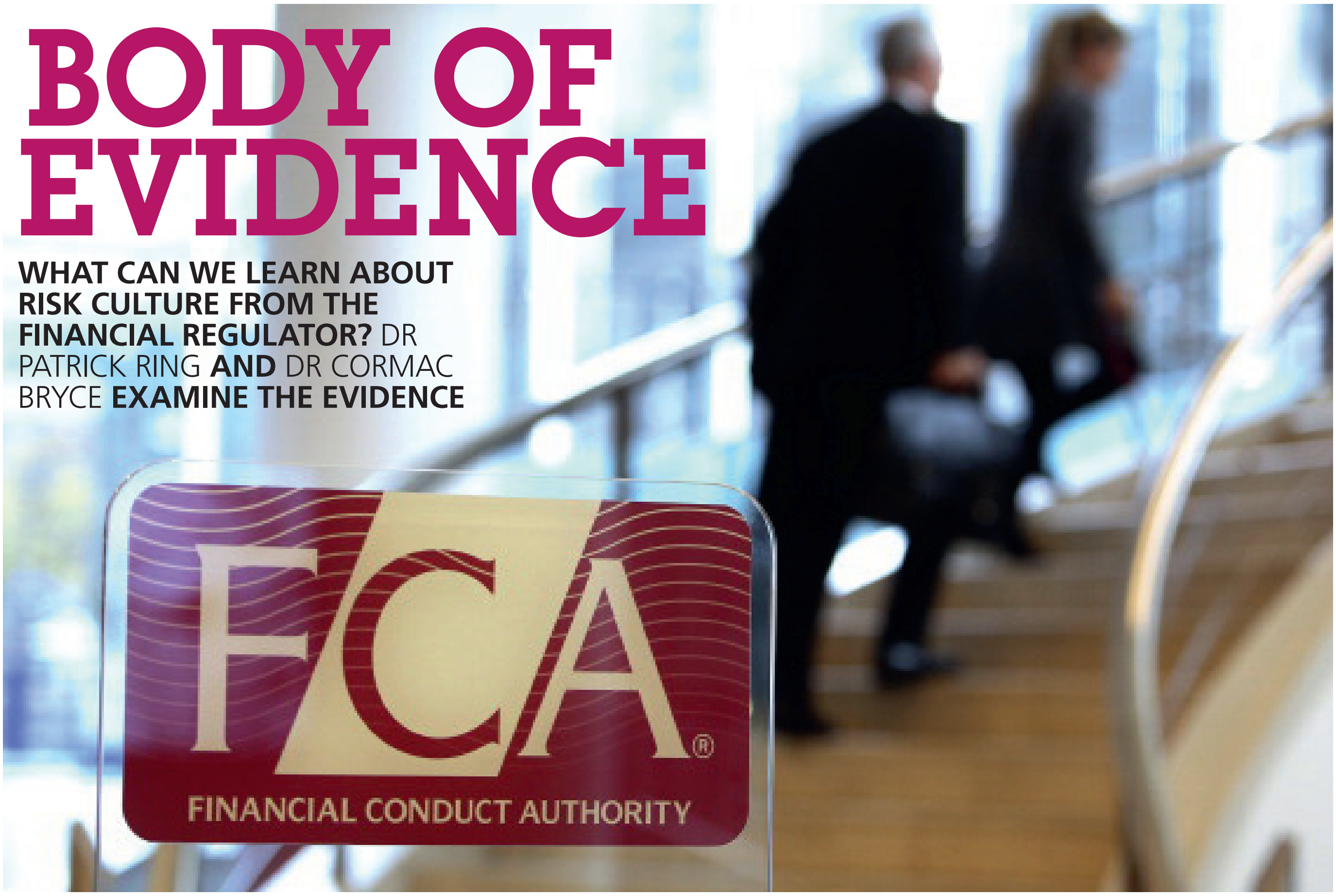
BODY OF EVIDENCE

WHAT CAN WE LEARN ABOUT RISK CULTURE FROM THE FINANCIAL REGULATOR? DR PATRICK RING **AND** DR CORMAC BRYCE **EXAMINE THE EVIDENCE**



'The crisis exposed significant shortcomings in the governance and risk management of firms and the culture and ethics which underpin them' (Hector Sants, FSA, 2012)In the wake of the financial crisis, the risk culture of financial organisations has come under significant industry, regulatory and academic scrutiny. This article looks at research that examines the UK financial regulator's approach to culture. The authors were particularly interested in the amount of regulatory guidance on managing risk culture actually available for practitioners and financial services firms.

This research was sparked by a specific example of the Financial Services Authority (FSA) – now the Financial Conduct Authority (FCA) – addressing culture in a 2012 thematic review about the risks to consumers resulting from financial incentives. It examined the practice of 22 authorised firms, and pinpointed the role of culture in the mis-selling of products. The regulator used examples from regulatory enforcement, with reference in each example to the relevant final notice (FN) issued under s.390 of the Financial Services and Markets Act 2000. These notices set out action taken against firms or individuals for breaches of regulatory requirements and explain the nature of, and reasons for, the breach.

Risk culture

the research started from the position – underlined by the FSA's own Enforcement Guide – that FNs can be used to communicate how the regulator interprets the relevance of (risk) culture in an organisation; particularly, the behaviours and actions which indicate what a good – or bad – risk culture looks like.

During the period 2010-12, senior FSA staff made at least 15 separate speeches specifically addressing the importance of the culture of firms operating in the financial services sector. Their general stance was:

'For regulators, the starting point should be that we want the firm to have a culture which encourages individuals to make the appropriate judgements and deliver the outcomes we are seeking... The regulator's focus should therefore be on what an unacceptable culture looks like and what outcomes that drives. It should not be on defining the culture itself.' (Hector Sants, FSA, 2010).

Clearly, while the regulator may not wish to define culture, it evidently wants to judge and assess it. What makes culture visible for the regulator, and enables it to make judgements, are the outcomes of firms' behaviour – as well as the way their employee behave, firm structures, and the systems and processes which 'incentivise' those outcomes.

We decided to examine all 160 final notices the FSA issued in 2012. We narrowed our search to exclude notices issued against individuals and one-person firms, on the basis that culture applies to groups, even though it is clearly influenced by individual behaviours and attitudes. This left 53 notices. We meticulously analysed them for any mention or reference to firms' culture, and found nine cases where there was meaningful discussion.

How the regulator understands culture

Our initial analysis highlighted several key issues. Firstly, it was clear the FSA was willing to describe a firm's culture, or at least the prevailing underlying attitudes and behaviours associated with that culture. In one example, it noted a 'culture of optimism' that resulted in risks not being managed adequately, while in another there was a 'culture of focusing on quick solutions'. The FSA also recognised the significance of subcultures within firms, such as assertive directors creating a culture of unquestioning support in their area, leading to a lack of effective controls and challenge.

These examples underlined the relevance of the ABC model of culture – the inter-relationship of attitudes, behaviour and culture within a firm. They also highlighted the importance of senior management actively understanding, developing and managing staff attitudes, rather than relying upon statements of values and aspirations in mission statements. This requires senior teams to get to grips with the 'nature', and therefore potential behavioural outcomes, of the culture in their firms.

Tone at the top

These cases also underlined the importance of the four key groups of behaviours identified in the IRM's own 'Risk Culture Aspects' model. Again, in several cases, the FSA pointed out the effect that the most senior personnel can have on the culture of the organisation – the 'tone at the top'. A number of cases also highlighted a lack of governance: for example, failing to comply with accounting standards; lack of disclosure and transparency; failure to manage conflicts of interest;

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and, in at least one case, the absence of a formal control framework.

Competency – or lack thereof – also proved problematic, with particular attention given to a lack of resources and inadequate skills causing risk management problems and gaps in the three lines of defence. Finally, several FNs illustrated how misaligned incentives and inadequate risk management resources led to poorly-informed decisions, and highlighted the nexus between these decisions, subsequent behaviours and the nature of the (risk) culture within the organisation.

The FNs emphasised the influence of both attitudes and behaviours on the organisation's culture. Of course, that culture also influenced the firms' subsequent behaviours – eventually creating the poor outcomes that made these FNs necessary. The FNs clearly provided lessons for firms and practitioners.

A regulatory cultural framework?

We were also interested in the ways the FNs discussed the FSA's own cultural framework. While rarely mentioned – even in 15 senior speeches – in 2007, the FSA had created its own 'cultural framework model' as part of its 'treating customers fairly' (TCF) initiative. The model created six key drivers of TCF 'culture', as well as setting out their indicators and contra-indicators. The drivers were: controls; decision-making; recruitment, training and competence; reward; leadership; and strategy. It's also worth noting that while organisational risk culture and TCF culture do not address identical issues, the models are similar, as they are both potential diagnostic tools, and identify similar issues regarding the development of a firm's culture.

As the regulator's cultural framework model was created to help firms comply with the regulator's sixth principle for business, treating customers fairly, we expected FNs involving breaches of that principle to discuss the cultural framework model. So we examined all 53 FNs relating to firms, but found only six involving a breach of the TCF principle. Surprisingly, while all six FNs mentioned one or more drivers in the TCF model, only one FN specifically discussed the issue of culture. Of these six cases we inspected them for discussion of the TCF model's six drivers. As in our first analysis of the FNs, we found examples of lack of challenge of decisions, misaligned incentives, poor leadership and controls, and training and competence problems.

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Final notices as a potential learning tool

Firstly, our research shows that FNs do not lend themselves to ready examination, particularly in identifying themes and specific issues. A change in format might remedy this, and recognise that FNs are read by firms, industry commentators and other interested parties. All of these stakeholders could benefit from an easily accessible document, drafted in a way that recognises its potential to educate. While the learning is there, FN's could usefully include more specific signposting of the lessons and themes that are discussed, given their obvious relevance to the risk management industry.

Secondly, the indicators of good and poor culture were already available in the TCF model by 2007. It is, therefore, disappointing that subsequent discussions of culture in regulatory speeches appear to have largely ignored the potential contribution of this structured approach. What is clear from examining the FNs is that, unsurprisingly, the drivers of TCF culture are relevant in the discussion of firm behaviour and outcomes, and that including them in such a discussion could be a useful learning tool.

Which leads to our third point. The FCA could do more in FNs to highlight the importance of the drivers and indicators of 'good' and 'poor' culture. FNs are, first and foremost, the FSA's enforcement division's formal documents, used in the context of action against a firm. In that sense, there has never been an explicit requirement for these documents to be framed as educative documents. Nevertheless, the regulator's guide to enforcement indicates that in deciding to publish its decisions, it should consider 'whether the publication sets out the [regulator's] expectations regarding behaviour in a particular area, and if so, whether that message still has educational value' (Section 6.10.A).

Failing all of this, the FCA may need to undertake more analysis itself. It has already used examples of FNs to discuss the culture of incentives. From there, it is a small step to providing an annual analysis of final notices. Given the continuing litany of events in the financial services sector, exposing inappropriate behaviours and attitudes, it is clear that the regulator – as well as financial services firms themselves – still have much work to do on the issue of risk culture. ■

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