

# The CULTURAL REVOLUTION

In the wake of the financial crisis, regulators are bearing down on banking institutions, while within them a quiet revolution is underway. Risk culture is a key focus of radical cultural reform, and much remains to be done, as Bangor Business School's Prof Ted Gardener explains.

**M**ajor cultural changes are taking place at banks worldwide. This quiet revolution is fundamentally about the development of a new risk culture and embedding it into strategy and operational management. The recent financial crisis has been a strong driver of these moves. In the more challenging post-crisis environment, banks are having to radically rethink their business models and respective corporate cultures.

Two of the major challenges facing the banking industry today are improving risk management governance in general, and specifically changing the kind of risk culture that characterised many banks before the financial crisis. These are necessary conditions for developing a more acceptable bank corporate culture model in the new, post-crisis environment.

## REGULATION AND CULTURE

The new Basel rules (Basel 2.5 and 3.0) were immediate and predictable responses to the

crisis. But regulators and other key bank stakeholders have to be careful about what they wish for. History has shown that excessively burdensome and restrictive bank regulations can help sow the seeds of the very events they want to avoid or at least mitigate. When bank regulations become overly constraining, they might create perverse incentives for banks to move into shadow banking – business that is unregulated and which may contribute to the build-up of new systemic risk potentials.

Bank regulators have long recognised the importance of governance and risk management culture within the required regulatory regime, and supervisory concern with these areas has intensified. A good example of this new supervisory concern is the strong and much more detailed focus on the required management responsibilities in key areas like liquidity, capital adequacy and stress testing. Top management is exhorted to lead and own the respective systems and decisions.

Nevertheless, regulators alone cannot change banking culture, although they may have a big influence on it. Banks have to assume responsibility for improving their own risk culture and ensuring that their entire corporate culture is consistent with and supportive of these changes. This is neither an easy nor speedy process.

The development of any firm's corporate culture is a complex and evolving concept. The national context (language, habit, geography, etc.) comprises one important set of factors. In the banking industry, regulation is both a national and international driver,



and it is particularly important. Even during the modern era of deregulation, banks have experienced a strong re-regulation of supervisory and other rules.

Alongside such external factors, bank corporate culture is shaped by other key drivers, like the firm's (especially its leaders') target systems and management style. Managerial targets have attracted particular scrutiny – especially the balance between target profit and the respective risks assumed to achieve profit. As competitive pressures have intensified, a strong ethos of selling and meeting sales targets has often displaced a marketing approach where customer-focused value propositions (and the profitable satisfaction of customers' needs) are more emphasised.

## RISK CULTURE

'Risk culture' and 'risk appetite' are key components of a bank's corporate culture. As with most areas of corporate culture, there are continuing debates about what the essential elements of a strong risk culture are, and how these might best be integrated within wider strategic and operational models. Nevertheless, there is a wide consensus that getting the risk culture right is an essential foundation, a necessary condition, for effective risk governance.

Risk culture, then, is a diverse area. Fundamentally, though, it boils down

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to how managers behave – specifically, their attitudes towards evaluating and managing risks – and how they balance such risks against the respective profit. It is about risk appetite, how much and what kinds of risk the bank is prepared to take, and embedding this risk appetite and the respective risk culture throughout the entire organisation.

In the modern development of bank risk culture, four drivers have been especially important and pervasive. Deregulation has intensified banking competition and innovation, thereby facilitating new profit and risk opportunities. Globalisation has diffused competition and innovation over national boundaries, and across previously segmented markets. The intensifying re-regulation of supervision has also helped to shape the kind of competition and wider business models deployed by banks. Within this maelstrom of change, technology has been a ubiquitous force of change.

The survey report 'Remaking financial services: risk management five years after the crisis' by EY and the Institute of International Finance, published last year, confirms that banks worldwide are now engaged in a kind

of risk culture revolution, and this has recently intensified. This survey found that "the largest shift this year is a renewed focus on risk culture". Important stakeholders (like society in general and Basel regulators in particular) have strongly reinforced the need for this risk culture revolution. Bank experiences during the financial crisis confirmed the overriding importance of a disciplined, top-down and risk-orientated management.

Survey evidence confirms that aligning the board, the leadership team and the banking business units around a shared understanding of risk culture is especially important. Risk culture has to be built from the top. Communicating and embedding risk culture throughout the organisation are still big challenges.

### STRIKING THE BALANCE

There is a widespread view that getting a risk appetite framework established has to be central in constructing a strong risk culture. One of the top challenges in strengthening the risk culture is striking the right balance between a sales-driven front office and a risk-focused culture. Developing

the required systems data and forward-looking risk metrics are also crucial.

The risk culture revolution is not an easy one, but it is a necessary part of the developing post-crisis banking environment. The new bank business models are inevitably shaped by these developments. Ultimately, the best insurance for the sustainability of free market banking is the quality and professionalism of bank staff, and those who run the organisation.

The recent intensification of the risk culture revolution in global banking is a positive development, but the evidence is that more work is still needed on culture and many banks are still struggling to ensure that business decisions are consistent with the bank's risk appetite. ©

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