Risk Culture – Does it Really Matter?

Leaders must communicate the meaning of genuine success!

We hear a lot about "risk culture." (See, for example, COSO's "Enterprise Risk Management – Integrated Framework" and the BIS "Corporate governance principles for banks") Is it a valid concept? How does one measure or recognize a good "risk culture?" How do executives create and sustain it?

Great Risk Management without a Risk Manager

Years ago I took a position creating and running a credit derivative business as part of a much larger capital markets team. Having filled risk management roles in prior postings, it surprised me that this new firm had no formal risk management. The only "risk manager" – though the formal title did not exist with this large financial institution – was the head trader. This man also supervised Operations and Information Technology for all of capital markets.

Surely this was a recipe for disaster! Yet it worked extremely well. This gentleman spent his day on the trading floor sitting in the middle of all traders and marketers. He did his share of trading and also scrutinized position and risk reports. He ran a tight ship and notoriously shut down trading on a few occasions when he considered his colleagues to be too lax in any way.

My conclusion then and now is that this unusual organizational structure worked in this specific situation. It worked because of the individual. This head trader was a man of few words and great integrity. Possibly because he was an engineer by training, he gave higher priority to running capital markets "by the book" than to "blowing the doors off" with a good quarter or trade.

Of course, the complete dependence on high integrity of one key person is also the great weakness of this org structure. There are too many examples of deliberate or incidental fraud in the financial world to permit comfort with the vesting of so many roles within one person.

Yet there is still a lesson to learn from my past employer. A powerful reason for the simultaneous success of the business and risk management was the clear communication of the head trader with *everybody* on the floor. He was physically among us. His message of "do things the right way" was simple and unmistakable and visibly enforced. There were no hidden trades, perverse incentives, or other dysfunctions that impeded full and open disclosure within the team.

What IS the Risk Manager's Job?

Segregating functions and roles of "the business" and "risk management" is far more conventional and typically solves the weakness of reliance on one or a small number of key employees. Yet this division creates its own problems. Most importantly, there is a loss of clarity in responsibility and authority.

In another role as a senior risk manager, I was "equal" in organizational stature to the head of the trading floor. The president of the firm explained my position to me in this way: "if we mess up, I'm going to ask [the head trader] 'why did you do that?' and then I'm going to ask you 'why did you let him do that?'"

Regardless of particulars, this statement captures well the management expectation that risk managers will act as policemen and lifeguards. Yet the business group people understandably prefer not to explain themselves to and share information with the policemen and lifeguards. The clear organizational division between business and risk creates its own cultural challenge. It would not be an exaggeration to say that the combination of this deliberate schism and regulatory compliance obligations define the "risk culture" of the typical financial firm.

The "Risk Silo" Creates a Flawed Risk Culture

It's a challenging problem! Good intentions aside, the formation of a unit such as "risk management" with a mandate to oversee and obstruct another unit must lead to tension and divisiveness. There is logic to this "silo arrangement" in that trading rules, limits, and models will have secondpair-of-eyes review. But the adversarial "people element" darkens the culture.

In an ideal world, all parties from the Board down to the trading floor would appreciate the logic and suppress the us-versus-them mentality. I've seen several financial organizations that approach this ideal, but in all cases there exists some level of distrust and uncooperative behavior between the silos.

Is there an organizational structure that would outperform the current paradigm? I believe there is, but I'll make that proposal in a future conversation. For now, I quote the football wisdom that "the best defense is a good offense." Instead of just a *risk* culture, what all financial and non-financial firms need is a strong *firm-wide* culture.

Communication and Content are the Core of Culture

Culture is the attitude and set of behaviors that pervade an organization. We sense the attitude and observe the behaviors of the people within corporate entities when we are employees ourselves of the firm or, more frequently, patrons, clients, vendors, or investors. We've all seen the good, the bad, and the ugly of corporate cultures.

Let's describe just the simplest of these three – the "good culture." Employees admire both their company and the goals of the company. They understand how their roles contribute to company goals. Employees are proud of their contribution and know that the company values their work. Employees share the goals of the company as their own.

With this description, all we need add are a few specific thoughts regarding financial firms, financial risk, and business success to define our desired *risk* culture. That is, strong *risk* culture is achievable in concert with strong firm-wide culture.

Though it's far more challenging to create "good culture" than to describe it, we state here the most important element. Communication is the core. Beginning with the CEO and Board, the firm must identify to employees and the public in plain terms why it exists and why it *should* exist. This "mission" and its communication must be genuine and inspiring.

The most prevalent "cultural error" of the financial world is to tell employees they'll have greater compensation as net income grows. The message is simple, which is good, and no employee has ever argued against greater compensation. But the monetary goal is self-serving and not inspirational. In a strong culture, the message is that financial success follows *genuine* success. Genuine success is fulfilling the firm's (inspiring) mission of serving others through the firm's core products and competencies. Many employees of the financial industry literally do not know what *genuine* success is for their firms. The leaders have not communicated!

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