Conduct Risk - Can you regulate risk culture?

Frances Cowell September, 2015

Revelations of market rigging, mis-selling, flaunting of anti-money-laundering laws, evident disregard for risk in the quest for revenue growth and the moral hazard intrinsic to large banks has prompted concern about the risk culture in those organisations. Recognising this, regulators and supervisors have sought to promote "good" risk culture, for example, by demanding that directors take responsibility for risk culture. In a new book by Frances Cowell and Matthew Levins[1], leading risk managers question how realistic this and other regulatory initiatives are.

Can you change an organisation's culture by fiat? Certainly you can mandate things like accountability, governance and incentive structures, for example by rewarding "risk-adjusted" rather than nominal revenue and by delaying bonus payments to allow for hidden risks to become apparent. But the word "culture" denotes respecting more than the letter of the regulation, which by definition cannot be mandated.

Even if banks' risk culture can be improved, it may not necessarily solve the risk culture problem. Banks, while bearing a clear responsibility in the crisis, may be only the most visible part of the puzzle, since neither regulators, politicians nor investors are blame-free.

One view is that some questionable practices may be tolerated in the interests of systemic stability. There is evidence, for example, that the Bank of England was aware of at least some rigging of LIBOR, but turned a blind eye, perhaps concerned that, were the true LIBOR rate recognised, it might have adversely affected the lending market.

A less benign effect may be regulatory capture, where regulators, earning a fraction of bankers' pay, seek favour with their charges so that they too may, before long, become bankers and earn a lot of money.

Being unable realistically to "prevent" another crisis, regulators' natural response is to protect their own interests, in other words, a poor risk culture.

Politicians, too, bear some responsibility as they sought electoral success by pursuing growth at all costs. Governments encouraged low-start home loans that ignored borrowers' capacity to repay. Cyclical slowdowns were averted with low interest rates even as evidence accumulated that cheap credit was feeding asset price bubbles and impeding the forces that self-correct built-up imbalances, thereby almost guaranteeing another crisis.

And many investors, responding to their own incentives of earning high yields in a low interest rate environment, were often negligent in scrutinising the risks of their investments.

[1] Crisis Wasted? Leading Risk Managers on Risk Culture. London, Wiley, 2015.

Clearly, improving the risk culture in financial organisations is an important initiative. But even when this is achieved, is it merely one hand clapping?