

Governance, Behavior & Culture

DNB's Supervision on Behavior & Culture within Financial Institutions

Wieke Scholten

DeNederlandscheBank

EUROSYSTEM

Executive Summary

Supervision on behavior & culture is an integral part of DNB's (governance & risk) methodology.

It assesses whether:

- leadership, decision making and group dynamics impede performance, stability and integrity
- institutions are effective in changing their businesses, including cultural change.

In addition, supervision on behavior & culture focuses on revealing the root cause of the issues at an institution that concern us, handing supervisors deeper knowledge of the institution and increasing the options for intervening and preventing issues.

Five years of experience has shown that risks pertaining to behavior & culture can be effectively mitigated/repaired.

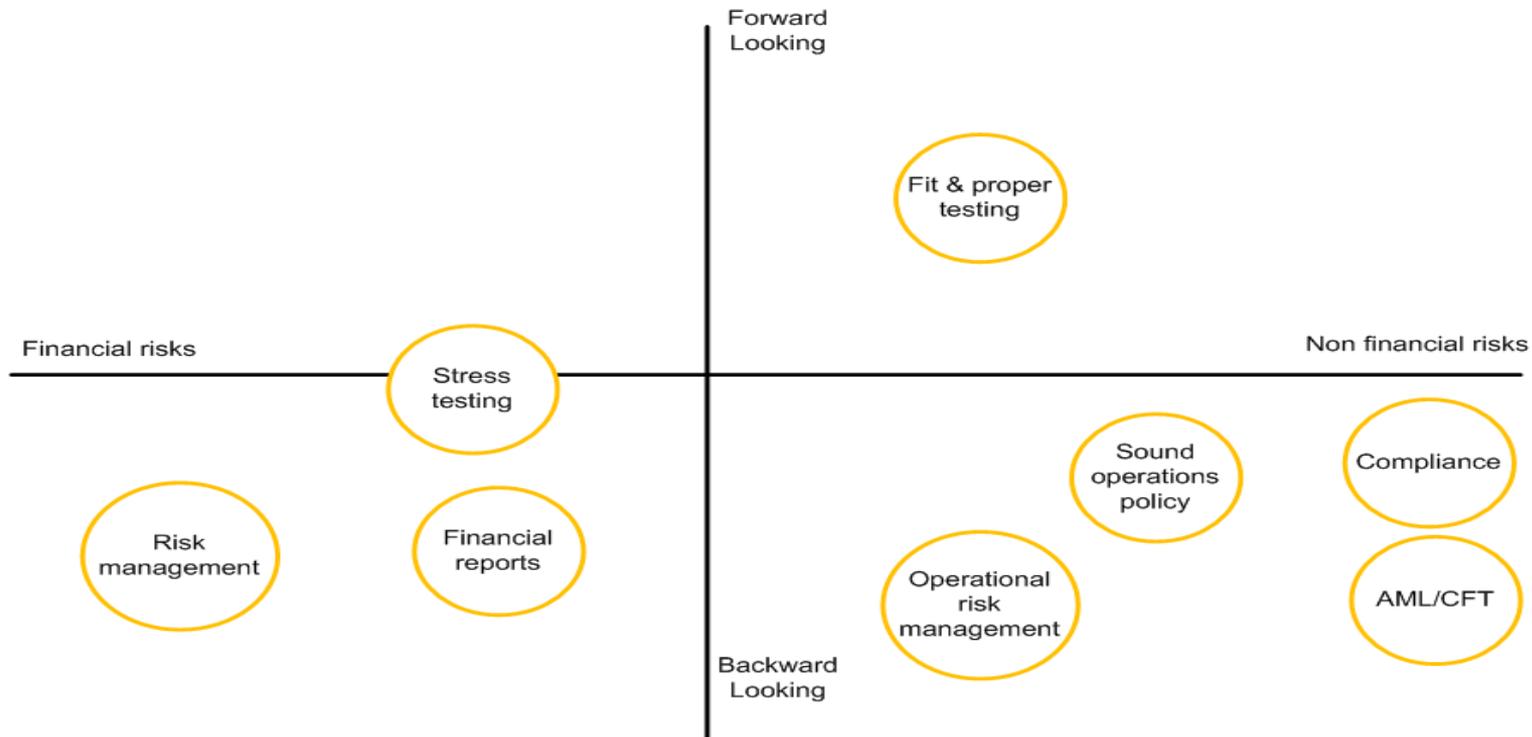
Supervision on behavior & culture was well received by financial supervisors, financial industry and Dutch press. *'It makes sense that DNB looks at behavior'*.

Introduction

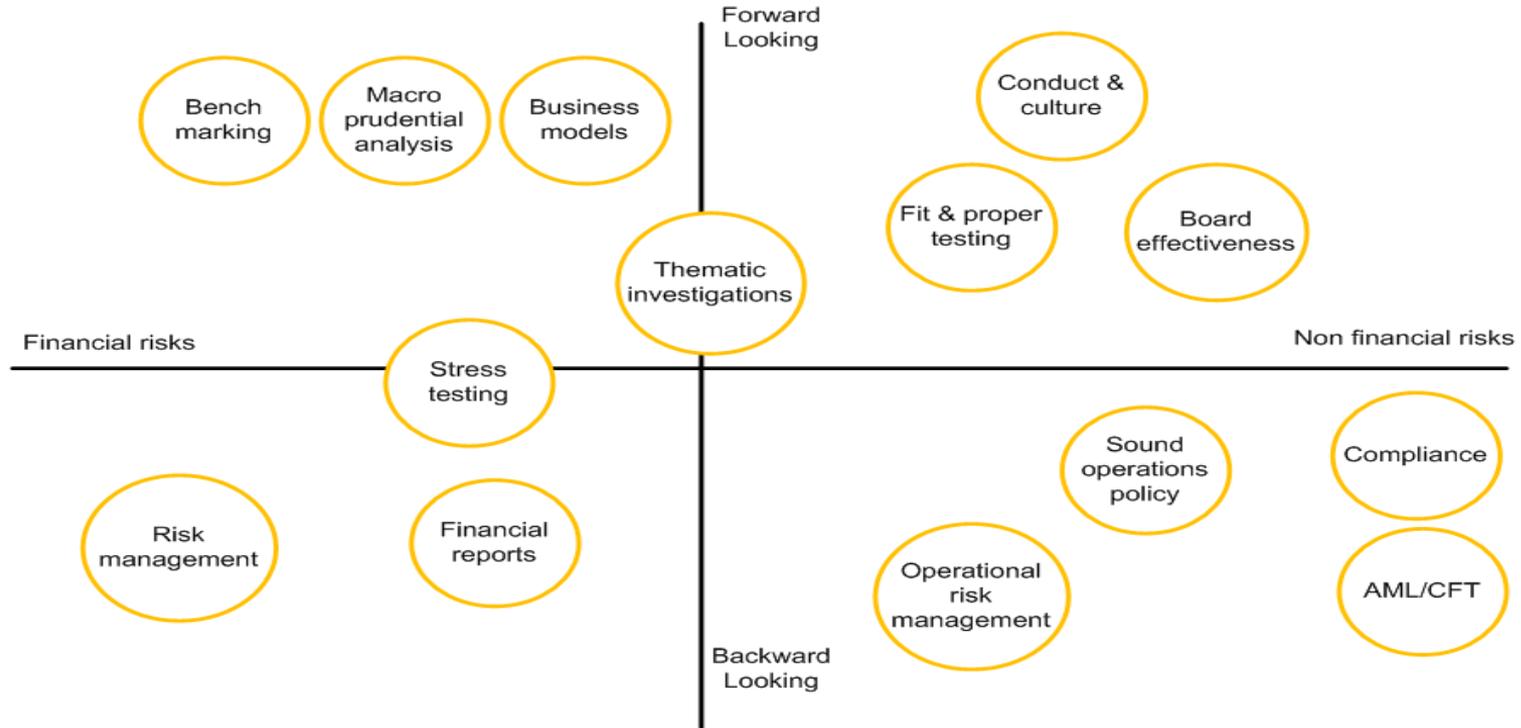
Why supervision on behavior & culture?

- One of the causes of the crisis: not so much inadequate governance structures, but board and management behavior within these structures
 - ⇒ People determine a company's performance
 - ⇒ A lot of supervisory issues have behavioral root causes
- Risks relating to behaviour may already be apparent, while financially everything seems okay:
 - ⇒ Behavior has predictive value with respect to future financial performance
 - ⇒ Early intervention may prevent future problems: forward looking, as business models and strategy
- More rules or more control alone will not prevent the next crisis

Pre-crisis supervision



Post-crisis supervision



Regulatory framework & international developments

- FSB Thematic Review on Risk Governance and Guidance on Assessing Risk Culture calls for supervisors to formally assess risk culture
- CRD IV and EBA GL 44 contain relevant provisions pertaining to behavior and culture
- ECB SSM Manual: chapters on Internal Governance & Risk
- BCBS Guidance Corporate Governance Principles for Banks
- Other Supervisors use similar techniques

Over 50 examinations on behavior & culture since 2010

Financial institutions	
Banks	20
Insurance companies	16
Pension funds	10
Trust	6
Total	52

Expertteam of Supervisors on Governance, Behavior & Culture

- Experienced in behavioral assessments and change management.
- Different backgrounds improve quality of supervision
 - Organisational & social psychology
 - Change management
 - Business administration
 - Law
- Working alongside with dedicated supervisory team

Culture versus behavior



Four assessment frameworks

Root Cause analysis

Behavioral patterns underlying different problems at one firm.

Board Effectiveness

Decision making, leadership, group dynamics, communication within executive management and/or a board. Leading by Example (2013)

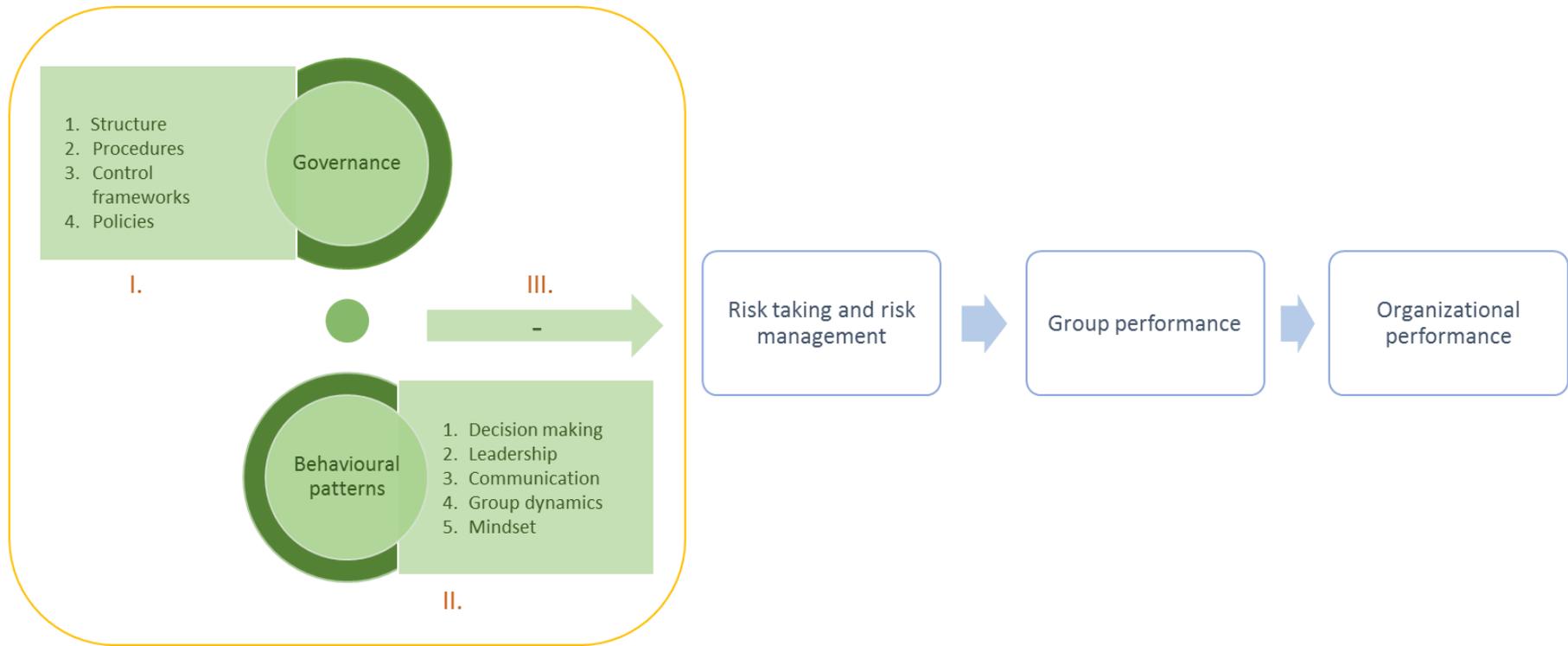
Risk Culture

Behavioral patterns that influence risk taking and risk management.

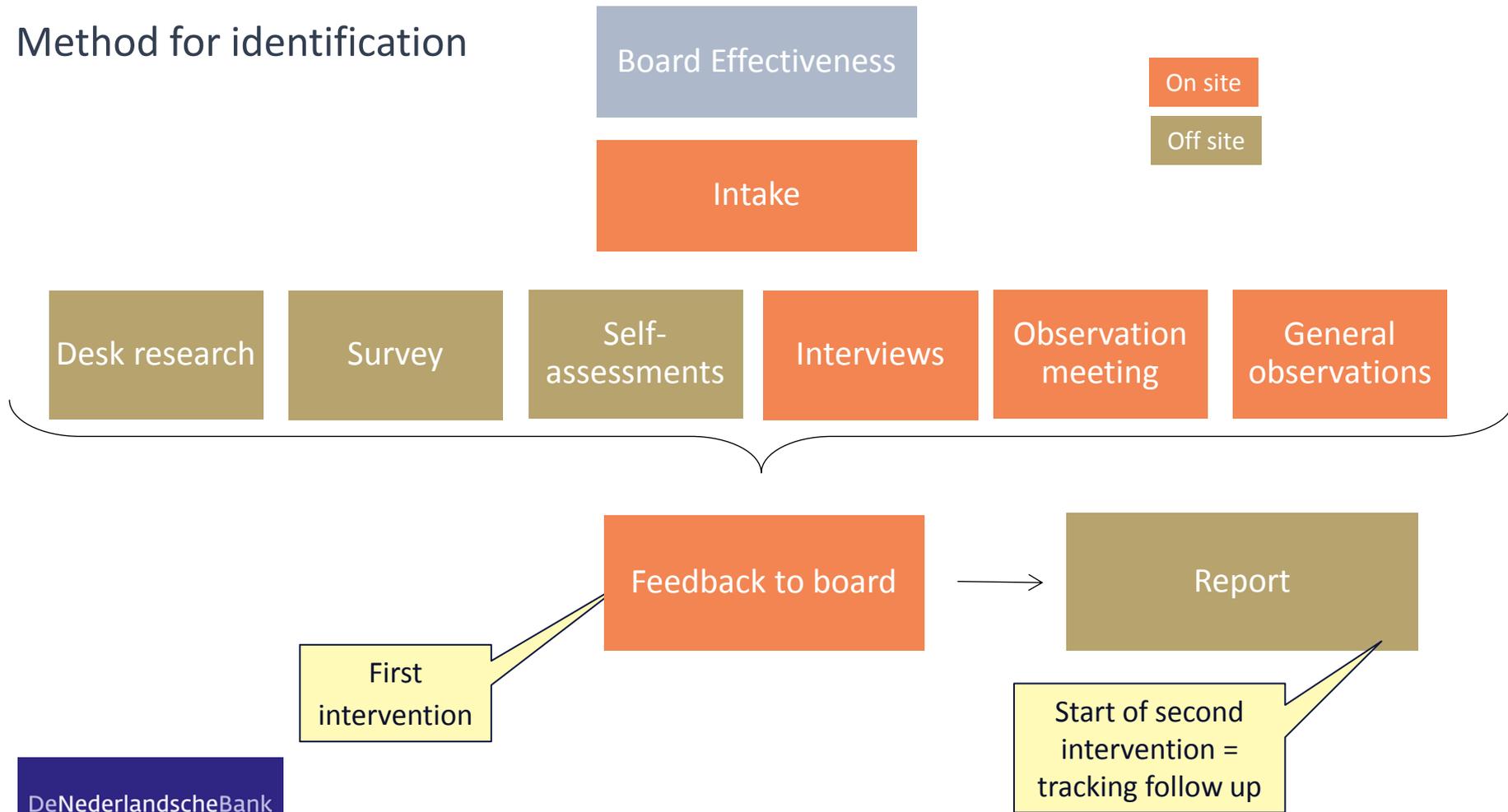
Change Effectiveness

*Strategy, change approach, execution, culture change.
Capacity for change in the financial sector (2014)*

Risk culture



Method for identification



Key aspects in identification and assessing risks

1. On site

You have to see and hear, go there. Up close and personal.

2. Triangulation (Jick, 1979; Jonker & Pennink, 2000)

Integrate quantitative and qualitative research methods, to come to a conclusion based on different angles.

3. Challenge

Four eyes principle. Everyone, all data. Several challenge sessions to go from observations to interpretation.

4. Professional judgement

Context, strategy, history influence weight of risks. No 'one size fits all': think in a minimum we want to see.

Key aspects in mitigating risks

1. Awareness

Focus on creating awareness: necessity for enduring behavioral change .

2. Confrontational dialogue

Most effective style is confrontational dialogue.

3. Multiple intervention strategy

Do not put all your eggs in one basket: choose multiple interventions. ‘Structure & social ‘ interventions.

4. Endurance

Stay with it, stick to your ground and persevere.

Example of questions

Decision making

- Can you describe the way this executive management team decides on complex matters? How is 'decision X' representative of the way decisions are made within this group?
- What was effective in this process? What was not effective? If you could improve one thing, what would that be?
- What is the typical style for decision making within this board? How do we know we are here and not at another bank?
- What was the 'flashpoint' in this specific decision making process? Who acted and in what way?

Group dynamics

- Not all people get along equally. Can you tell us about what subgroups (alliances) exist? How do you as a chair deal with this, can you use that for the better?
- How do you look at the diversity of the board in terms of age, gender, background etc. How does this diversity affect the decision making process?
- Tell us about the last time you as a chair had to intervene in the group dynamic. What made you intervene?

Kind of behavior observed

Decision making

- constructive debate: quality of challenge
- Informal / formal decision making
- quality of information

Leadership

- leadership styles and its effect on (organizational) climate
- inviting people to speak up
- being able and willing to reflect on own behavior

Group dynamics

- within group (like a board), but also between groups (business vs control functions)
- overconfidence, unanimity, social loafing
- striving for premature consensus or willingness and openness to discussion and critical debate

Communication

- transparency
- tone of voice
- information (a)symmetry

Risks identified within board and executive management

- Dominant leadership of CEO and following board members / senior management
 - Impedes constructive dissent
- Unsatisfactory adherence to (strategic) objectives
 - Risky decisions with financial loss as a result
 - No strategic direction: opportunistic decision-making
- Decisions are insufficiently challenged / discussed at executive and board level
 - As a result no countervailing power towards CEO or CFO
- Informal decision making renders formal organisation 'obsolete'
 - Key people / relevant disciplines not involved
 - Absence of sound judgment, balanced risk analysis

Supervisory mitigation and effects

Actual changes

- Changes in the way stakes are discussed and decisions are made
- Reinforcement of Governance structures and principles (appointing a devil's advocate, organising countervailing power)
- Enhancing countervailing power through reinforcing role of independent directors on board and 2nd & 3rd lines of defence
- More organized reflection on complex decision making and group dynamics.
- In some occasions our supervision led to dismissal of employees / executives / board members.

Overall effect

- Increased awareness at Dutch banks on the effects and risks of their behavioral patterns.
- Dedicated supervisory teams acquired a more comprehensive overview of the (root) causes of many supervisory issues pertaining to the institution.

Reactions to supervision on behavior & culture

Financial industry

- “Makes sense that DNB looks at executive and board behavior”, initial sceptics are “overruled” by peers
- High regard for this type of supervision due to skilled supervisors and “professional and respectful” performance of supervision (even while it lead to tough consequences)

Press

- Positive press coverage

Dedicated supervisory teams at DNB

- Initial scepticism has vanished and has been replaced by support due to added value for financial supervision

Other supervisors

- Other supervisors also use several techniques (board effectiveness, observations)
- DNB contributed to FSB with respect to risk culture and seconded employees to international supervisors
- DNB strives to strengthen approach on culture and behavior in European banking supervision

- IMF Financial Stability Report October 2014 (Chapter 3)

Thank you

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