Conduct in the board rooms of financial institutions

Leading by example

De Nederlandsche Bank
Eurosysteem

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Directors of financial institutions are insufficiently focused on, or aware of, their own conduct and the group dynamics that influence performances and outcomes

Assessments that DNB performed in the context of its supervision on conduct and culture show that directors and supervisory board members tend to give insufficient attention to the human aspects that define the success and effectiveness of an organisation. Focussing only on performance and substance, they tend to emphasize the importance of professional expertise. These are the qualities they regard as the key ingredients for optimal performance. However, we have also encountered institutions that applied a two-fold approach, in which attention was given to conduct as well as substance. Senior managers in these institutions attach importance to their own conduct and, for example, set aside time to reflect on their own teamwork, leadership and approach to decision-making.

Conduct and culture can predict the performance of institutions

Insufficient attention for one's own behaviour and/or group dynamics can affect financial performance, the integrity and reputation of institutions, and hence confidence in the financial sector.
Inadequate attention to patterns of conduct and group dynamics can cause risky behaviour to persist. Examples of such behaviour are senior managers who dominate the decision-making process.

Or a managing board where two opposing sides pursue only their own subsidiary interests. Or directors who are shy of bringing their opinion forward in board meetings. All are examples of conduct that compromises good results and a healthy organisational climate.
Nowadays DNB addresses these aspects as part of its supervision, so as to pinpoint problems at an early stage, before they result in poor (financial) performance.
Since 2011, conduct and culture have been a spearhead in DNB's supervisory activities. In 2011 and 2012, approximately 30 banks, insurers and pension funds of various sizes were assessed on conduct and culture.
DNB looked at the managing and supervisory boards, examining aspects such as leadership, internal and external decision-making, communication and group dynamics. Each assessment resulted in what we refer to as 'institution-specific findings'. These are and will remain confidential. This report presents a generic picture of the main outcomes of all conduct and culture assessments.

Four key areas in our supervision of conduct and culture

DNB expects financial institutions to address the following four key areas.

a. Specific action to enhance attention to conduct and group dynamics

Directors and supervisory board members need to be aware of their own conduct and above all of the impact it can have on others, on dynamics within the group and on the human and business performance of the organisation. This requires an understanding of how emotions, convictions, interests and ethical values influence these aspects. DNB believes that self-reflection and addressing one another on conduct are crucial to the success of an organisation. Board members in the financial sector are therefore asked to reflect on and learn from their own conduct so that they may convert negative behaviour into patterns that can make a positive contribution. Directors and supervisory board members must therefore take the time to look at their own conduct and the dynamics within their peer group.

The assessment provides a mixed picture on this aspect. Several organisations are in one way or another actively working on self-awareness. However, many others are doing very little. There, directors and supervisory board members rarely address one another on undesirable or ineffectual conduct.

Still, most financial institutions do acknowledge the importance of conduct and culture and the vital role of awareness of one's personal behaviour and group-dynamics for the success of the organisation, even though many have only a vague idea on how to translate this awareness into concrete policies and procedures.

Example of good practice

In our assessments, we came across a board that was actively working to improve its own conduct. This particular board had taken the time to get to know each other. What is each members' personal attitude? What is each member's professional background? Where does everyone come from and what do they find important? Which role suits each person best and what annoys them? Patterns of group dynamics were regularly and openly discussed both in day-to-day operational meetings and during regular off-site sessions. External support was sought. This enabled the board to identify its own characteristic patterns of behaviour and convert negative patterns into positive ones. This in turn enhanced the quality of their decision-making, their teamwork and the organisational climate as a whole.

b. Sound judgement

DNB expects managing, supervisory and pension fund boards to exercise sound judgment. This means that their members must actively ask questions, engage in constructive discussion and challenge one another in the context of forming a judgment.[1]

An approach of this kind can prevent decisions from being taken on the basis of inadequate or inaccurate facts and assumptions, risks from being overlooked, insufficient account being taken of the interests of all stakeholders and better alternatives being left out of the equation.

The assessments identified various cases where the risks involved in a particular decision were not sufficiently considered. In some cases, this resulted in actual financial losses.

c. Organising critical dialogue

In the same context, we found it remarkable how few organisations had taken structural measures to organise critical dialogue within the top of the organisation. This is not to say that critical dialogue is entirely absent within these organisations. However, where critical dialogue is expressed, this is often merely the unintentional result of favourable board composition and high quality personal input from the members of the supervisory body.

DNB considers it important for organisations to take more specific measures to promote critical dialogue. This helps ensure adequate discussion of all relevant risks and prevents decision-making from becoming overly dependent on interpersonal dynamics.

Example of bad practice

In our research, we came across several examples of ineffectual relationships between managing and supervisory boards, as well as working relationships that were strongly defined by conflict. One example was a managing board that claimed their supervisory board was out to 'grill' them. The supervisory board described the managing board's responses as 'defensive'. This situation led to mutual annoyances. In short, the managing and supervisory board members expressed little confidence in the management capabilities of 'the opposite camp'. Lack of confidence erodes effective cooperation and constitutes a risk for decision-making processes. Conversely, we also encountered working relationships that were characterised by a strong desire for harmony. This in turn creates a risk that the desire for unanimity prevents alternatives from being explored.

1 Financial Reporting Council (FRC) Guidance on Board Effectiveness

d. Flexible leadership style for chairpersons

Our assessments have shown that a dominant leadership style among many managing, supervisory and pension board chairpersons is the preferred style. DNB believes however that chairpersons should be capable of flexibly applying several leadership styles, depending on the situation. For example, a dominant leader should also be capable of exercising a more facilitating role.[2] Facilitating leadership – of which the assessment also identified numerous examples – means that the chairperson ensures that all relevant group members and key officers take part in the decision-making process, gauges the role and opinions of every group member and helps them to conduct a high quality discussion. The assessments also show that a facilitating style encourages counterarguments and ultimately leads to a more carefully considered and hence better decision, since more alternatives, facts and risks are taken into account.

We will be giving specific attention to all four areas in our supervision of conduct and culture during the year ahead.

Effects of supervision on conduct and culture to date

One important effect of DNB's focus on conduct and culture is that directors and supervisory board members have become more aware of the risks emanating from the way people behave. This heightened awareness in many instances resulted in specific measures.
Most institutions that showed high risk conduct took decisive measures to eliminate those risks.
Some organisations effected changes to the board, while others, following our assessments, strengthened their corporate governance, revised their strategy, attended coaching and/or boosted their critical capacity.

Cultural change requires on-going attention from directors and supervisory board members

It is vital that attention for conduct and culture is strengthened still further. Not just within boardrooms but downwards throughout the organisations. After all, the aim is to change the prevailing culture within large and complex organisations and even across an entire sector. Such a change can only come about if directors and supervisory board members make long-term an consistent adjustments to their management approach. DNB will not only monitor these developments – and where necessary provide directional guidance – it will also proactively encourage them. This calls for intensive supervision. In addition, DNB will provide education and training. In 2013, DNB shall – together with AFM – conduct thematic assessments to find out whether organisations are capable of implementing the changes required.

2 See the FRC Guidance on Board Effectiveness concerning the role of the chairman of a one-tier board in the UK

Some of the institutions that were assessed indicated that are planning to organise internal investigations into conduct and culture, using the DNB assessment methodology. We are happy to support these institutions, for example by helping to train their internal investigators. This ties in with DNB's wider strategy that combines intervention in order to tackle undesirable behaviour with active encouragement to make the necessary improvements. The ultimate aim is to bring about a lasting change of behaviour within the financial institutions where conduct and culture currently impedes sound business practices.

Guide to the table of findings

This document concludes with the table below setting forth our assessment findings. In this table, the first column describes a number of findings relating to leadership, decision-making, group dynamics and communication based on the supervision of conduct and culture. The second column summarises the potential or observed negative consequences or effects of these findings. The third column outlines a number of good practices: these are examples of how negative findings may be turned into positive outcomes. Several of these good practices were observed within the organisations studied.

<table>
<tr><th>Findings</th><th>Effects, consequences</th><th>Examples of good practice</th></tr>
<tr><td>Leadership</td><td></td><td></td></tr>
<tr><td>Dominance of the chairperson/managing board due to:
- Strong personality (the will of one individual is law);
- “Rough” style of communication;
- Superior knowledge and information advantage of managing board;
- Perceived need to struggle for survival and sense of urgency;
- Chair first gives own views at start of meeting.</td><td>• Too little or no debate: too few critical comments either within the managing board or from the rest of the organisation => not all key individuals are involved and not all the facts /risks are presented
• The climate of the organisation is being negatively influenced: dominance creates dependency in an organisation and leads to a wait-and-see attitude which undermines individual responsibility.</td><td rowspan="3">Flexibility of style: Leaders must have the capacity to alternate between different styles, depending on the given situation and context. A necessary precondition is that the leader is aware of his/her own style and knows which style is required in which situation.

Facilitating leadership, focussing on:
1) active and effective participation by all relevant people and functions;
2) a satisfactory outcome of the decision-making process;
3) acceptance of the resulting decision by all stakeholders;
4) attaining the result within a specified timeframe;
5) interaction and relationships between board members

The result of facilitating leadership is to promote debate and participation, so that all positions, risks and alternatives of a decision are discussed constructively. Using various methods and techniques to encourage and facilitate:
- Reflection on one’s own conduct and the dynamics within the group;
- Addressing each other on conduct.</td></tr>
<tr><td>Chair fails to adequately lead the meeting (laissez-faire leadership style).</td><td>• Chaotic decision-making with no real dialogue; difficult issues remain un-discussed. This often also leads to slow decision-making.</td></tr>
<tr><td>Pseudo-facilitation: although the chair lets everyone have a say, he/she ends with a highly decisive (alternative) vision of his/her own and doesn’t take other people’s input into consideration.</td><td>• Undermines the chairperson’s credibility and leads to passivity and mistrust.</td></tr>
</table>

Decision-making		
• The role and task allocation within a board and/or between boards in the context of the decision-making process is unclear (may also include the group/shareholder/advisors) • Concomitantly: informal decision-making undermines formal decision-making processes and/or the responsibilities of individuals and/or control functions • Risks and/or stakeholder interests are inadequately charted, weighed against each other and/or (visibly) reflected in decisions • Expedient departure from strategy or stated objectives	• Not all key individuals and/or control functions are involved in the decision-making process. Too ew new angles are explored, risks aren't properly taken into account or discussed in depth and better alternatives unconsidered => low-quality decisions • Decision-making is not balanced • Decision-making is inconsistent	**Critical dialogue:** organise meetings so as to encourage critical dialogue. A first condition is that the tasks and responsibilities of those involved are clearly described and that mutual expectations are communicated. Simple measures (such as appointing a devil's advocate, working in sub-groups, etc.) can then be used to improve the quality of preparatory work and the discussion of decisions. Finally, a third party can if necessary be asked to monitor dynamics within and between all stakeholders. **Stepped decision-making process:** In which – for complex subjects – the phases of information-gathering on the one hand and of deliberation and decision-making on the other are deliberately separated. An initial discussion is used to explore the subject and to consider all angles, perspectives and relevant interests. There is no place for deliberation in this phase. The advantage is that all stakeholders are 'forced' to examine the facts, interests and possible alternative angles in depth. The judgement and decision-making phase starts in a second discussion, in which possible scenarios (together with pros and cons) are thought through. These scenarios can be prepared in a small committee based on the outcomes of the irst meeting. The similarities and differences in viewpoints are then charted and a decision taken as to which scenario looks likely to receive the most support. The next step (in the form of a third meeting if required) is to move to the actual decision-making stage. Stepped decision-making broadens support for decisions and promotes a balanced consideration of all the interests of those involved.

Group dynamics		
• Unclear division of duties between the managing and supervisory boards (may extend to the shareholder/group/advisors) • Lack of trust between the managing and supervisory boards • Seeming unanimity within the managing boards (symptoms of group-think) • Supervisory board is insufficiently critical of the managing board • Too little cohesion within the managing board (and leadership is not working towards team-building) • Collective optimism within institution • Limited reflective capacity within the managing and supervisory boards • Low level of diversity • Mutual hierarchy and seniority stand in the way of cooperation • Experience is perceived by senior supervisory board members as equivalent to critical capacity • Tendency to work towards consensus • Difficult emotional, human issues and/or fundamental choices are not discussed • Proven track record/performances prompt a self-satisfied attitude, an illusion of control and less tendency to call each other to account on conduct • Pension fund board is not a unitary board: division along employer/employee lines	• All the findings effectively conclude that there is insufficient critical dialogue, both within and between the managing and supervisory boards. As a result, the facts as presented are taken for granted, risks are not identified and better alternatives are not fully discussed => solutions are too quickly implemented without proper dialogue • Lack of reflection means that risky patterns of behaviour are allowed to persist • There is no independent managing forum to jointly represent the interests of all those involved with a pension fund. Instead, each 'camp' represents only the interests of its own membership	Using various methods and techniques to **encourage** and **facilitate**: • Reflection on one's own conduct and the dynamics within the group; • Learning to recognise each other's individual contributions, qualities and pitfalls; • Actively working to improve mutual cooperation; • Addressing each other on conduct. Coaching sessions, externally supervised evaluations, organising frequent reflection days for the managing and supervisory boards.

Communication		
• Non-productive communication styles (either too brusque or too polite) and/or lack of clear or open communication between the managing and supervisory board members • There is no (clear) strategy, or else the existing strategy is not clearly communicated to the organisation's employees	• Lack of constructive and exhaustive dialogue => facts and risks remain un-discussed and not enough time is given to thinking up better alternatives • Without a clear strategy, employees simply act on their own accord, with the result that the wrong decisions are taken, responsibilities are not assumed and misunderstandings occur in reciprocal communication => reduced mutual trust and lack of decisiveness on the part of the institution	**Strategy sessions** in which the head of (a division of) the institution outlines the strategy and explains why specific decisions have of haven't helped to realise it. This clearly shows to the individual employee how their day-to-day work contributes to the strategic goal. This in turn boosts decisiveness and a sense of direction within the institution. **Manifest** Directors speak with one voice and project a single image to their organisation. Staff are included in day-to-day choices to be made. **Reflection** on one's own communication style; **addressing each other** on conduct.

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