Change, Culture & Risk:

"Oh, no! Not another article about culture!"

In sympathy with that reaction, three precise questions are posed. If you answer is yes to all of them, then read on. Otherwise, get back to what's on your desk or look at the other articles in this magazine.

1. Are you in charge of anything that affects the institution's risk level?
2. Do you believe that there is a dysfunctional lack of understanding of the institution's core values concerning risk appetite and risk taking?
3. Do you want to deliberately address and narrow that *risk vision gap*?

This article is motivated by three strongly held and perhaps controversial views. The first is that financial institutions need to pay more attention to understanding and communicating their collective values around "risk." There can never be enough attention or dialogue on this topic. The second observation is best put as a question: Have financial services companies approached the point where our reliance on mathematics, models, and markets has led to a dangerous lack of attention to the softer, less quantifiable variables that drive risk? A philosopher once observed that "the last thing a fish would discover would be water." Could bankers have the same perceptual failing around risk? This seems particularly true at this moment in history, as our technological and marketing sophistication perhaps has outstripped an instinctive prudence that was embedded in our risk management genes. The third and least controversial conviction concerns the inevitability of change. Ironically, there is widespread agreement that banking has changed enormously in a relatively short time and that, on balance, those changes have been highly positive. Banking is not only different: it is better, safer, friendlier, faster, etc. On the other hand, that very change has accentuated the need for a focus on the "soft" variables one more time, particularly our core values around risk appetite and risk taking.

The Contemporary Setting

Clearly, all is not well in the world of financial services. The recent business press (and public consciousness) is peppered with incident after incident in which a financial institution has tested the limits both of its risk management infrastructure and the public trust. Just consider these recent and disturbing *Wall Street Journal* headlines:

- "Freddie May Have Understated Profits by Up to $4.5 Billion" (June 26, 2003).
- "BofA Sought Assets, Got Troubles" (Sept. 12, 2003).

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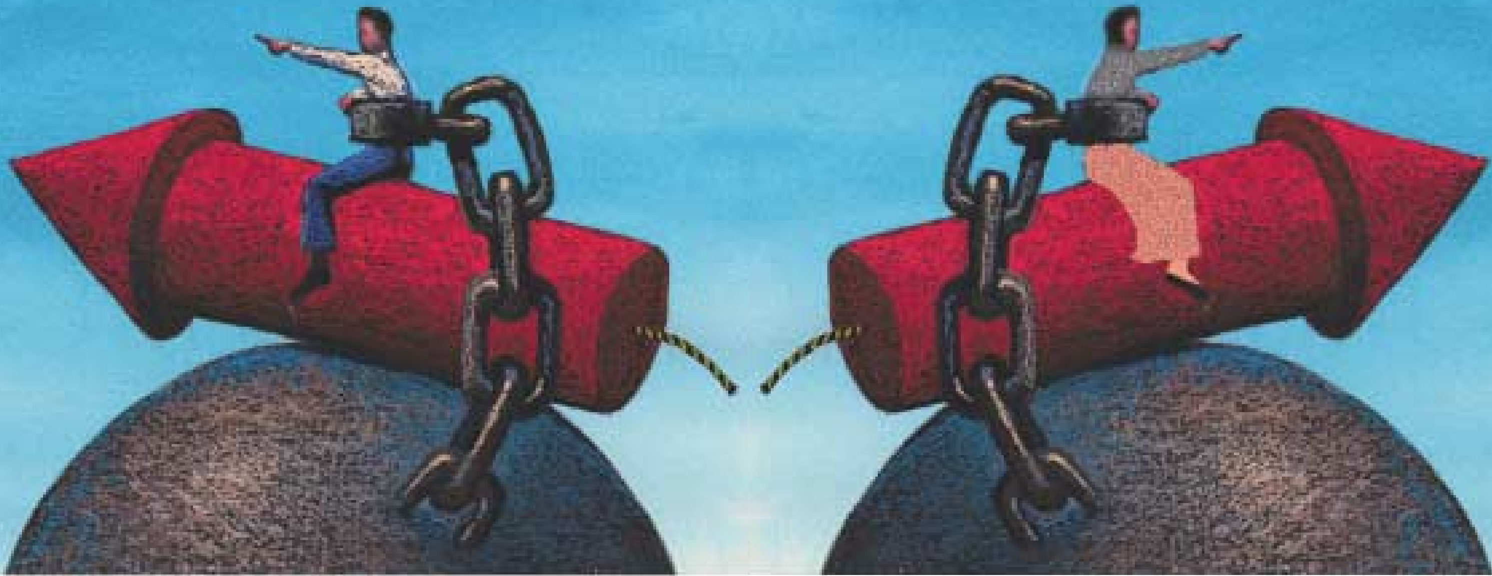
A Primer for Financial Services Executives with Agendas

by Thomas R. Hofstedt



- "Home Loan Bank's Woes Increase" (Oct. 1, 2003).
- "AIG is Charged by SEC With Fraud" (Sept. 12, 2003).
- "Scandal Scorecard" (featuring Merrill Lynch & others—Oct. 3, 2003).
- "Home Loan Bank's Woes Fuel Debate on Risk" (Sept. 29, 2003).
- "Mortgage Hedges Have Big Impact on Rate Changes" (Sept. 25, 2003).
- "Mizuho Holdings Expects to Post Widest Net Loss Ever" (Jan. 22, 2003).
- "A Banking Success Story Draws Questions" (May 12, 2003).

What's going on? Are these events—as the new crop of enterprise-wide risk management practitioners might intone—merely Six Sigma VaR anomalies? Or do they signal genuinely systemic problems? We can only acknowledge that each incident is different and that context is important, then resort to platitudes like "time will tell" (although managers, shareholders, and regulators do not have that luxury).

Some Scenarios

Assume that you are the newly appointed CEO of a mediocre financial institution, strongly motivated by a conviction that the company can become truly great. You are determined to make it so. Alternatively, perhaps you are the head of a perfectly fine operation—a leader in its industry—but you foresee massive change just over the horizon, a coming tectonic shock that your firm (partly because its success has made it smug) is ill prepared for. Or consider yourself a surviving CEO of two merged institutions, forced together by market necessity but with incompatible styles, marketplace strategies, and value systems. Or you are a brand new board member and Audit Committee chair of an "intervened" bank, one snatched from the brink of insolvency by a regulatory agency. Or you've just taken on the newly created position of chief risk officer.

Are these enviable career opportunities? Or an organizational graveyard for well-intentioned leaders? These apparently disparate contexts have three important commonalities. The first and most obvious is that change is mandated. Perhaps more than almost any other sector today, banking is about anticipating, adapting to, and managing continuous change. These are the critical (and scarce) skills in managing financial institutions. The second but slightly less obvious reality is that the changes will

require a deliberate intervention into the culture of the organization, particularly those elements dealing with risk-taking attitudes and behaviors. The third common element is that there will be massive confusion over the best way to manage that intervention. This confusion has spawned an entire subculture of "culture consultants" and has (arguably) led to more wasted money than any nightmarish loan portfolio ever did.

Too strong, you think? Let us invoke a "man from Mars" perspective on banking; or, better yet, use your own experience to react to the following series of episodes from modern banking:

- The executive team of a global financial institution spends $10 million (and 2,000 person/days in confrontational small group sessions) to "develop a sense of shared values."
- A regional bank in a high-growth environment announces that 45% of its commercial portfolio is classified in the "problem" category. Senior management attributes it to "bad luck and the bubble economy."
- A major consultant attracts bank clients by advocating a change program designed to achieve "zero loan losses."
- A just-appointed chief executive officer (who comes from a nonfinancial institution) announces that the bank has a "new risk vision" characterized by five "core values."

If each of these does not sound at least faintly preposterous to you, then you are either (a) a consultant with wares to sell, (b) Franz Kafka reincarnated, or (c) a bank manager burned out by waves of organizational change projects. Interestingly, each of these pathological episodes involved a well-placed concern for "culture." Also, each illustrates a fundamental misunderstanding of what it is and how change must pay attention to it.

Some Terminological Clarification

Culture is a readily understood part of our everyday vocabulary: It refers to shared values and common ways of thinking and doing things. We are comfortable with the notion that different countries, professions, or eras can be distinguished from one another by their value systems. Doctors and lawyers and bankers are different; Victorian England was not the same as modern America; a small community bank embedded in an agriculturally based region will be driven by a different ethos than a global megabank holding company (see inset, above).

> **Two Case Studies of Value Contagion**
>
> **Case A:** In the latter 1990s, the largest bank holding companies focused on the rapidly growing and highly profitable investment banking opportunities. This focus shaped enterprise-wide risk management systems and policies and drove credit decision making at the transactional level. Some of the effects were pernicious, leading to fired executives, jury trials, and large fines. Other effects were beneficial and long lasting, e.g., improvements in risk metrics.
>
> **Case B:** The CEO of a $500 million community bank embedded in a declining rust belt city developed a vision that featured the bank as the engine for community redevelopment. He committed all of his time and energy to that vision, and the bank's advertising and marketing strategies were aligned with that vision. Over the next 18 months, the bank's customer mix and loan portfolio shifted to reflect public and quasi-public agencies, social programs, and start-up commercial ventures concentrated in the downtown area. The bank was subsequently acquired by an out-of-town institution that offered shareholders a 50% premium.

However, it gets murky when we start attaching adjectives to the term *culture*. The three adjectives that are in vogue are *corporate*, *credit*, and (quite recently) *risk*. Are these the same? Does one drive the other? What are the linkages? These questions are unimportant for some institutions. A $200 million community bank—due to its size and relative simplicity—may be able to define its organizational (corporate) culture in terms that also describe its risk and credit culture. On the other hand, a diversified financial institution offering commercial, investment, consumer, trading, insurance, and brokerage financial services will have a welter of interlocking and conflicting subcultures.

There is a natural hierarchy. Corporate culture drives risk culture which drives credit culture. If you can make prescriptive statements about one, those statements should shape the values and practices of the subordinate cultures. There are two important corollaries. The first is to acknowledge the contagion possibilities. It takes place at two levels. First, values flow from top to bottom. Generally (but with lots of exceptions), people will try to do what they think the boss wants them to do. Secondly, values drive tactics and behaviors. Figure 1 illustrates both of these

causal forces: higher order values drive lower order values and values at any level drive behaviors.

The other (highly frustrating) corollary is that you can neither define nor change the lesser cultures without worrying about the higher order cultures. This is why description, diagnosis and change must start at the top of the organization.

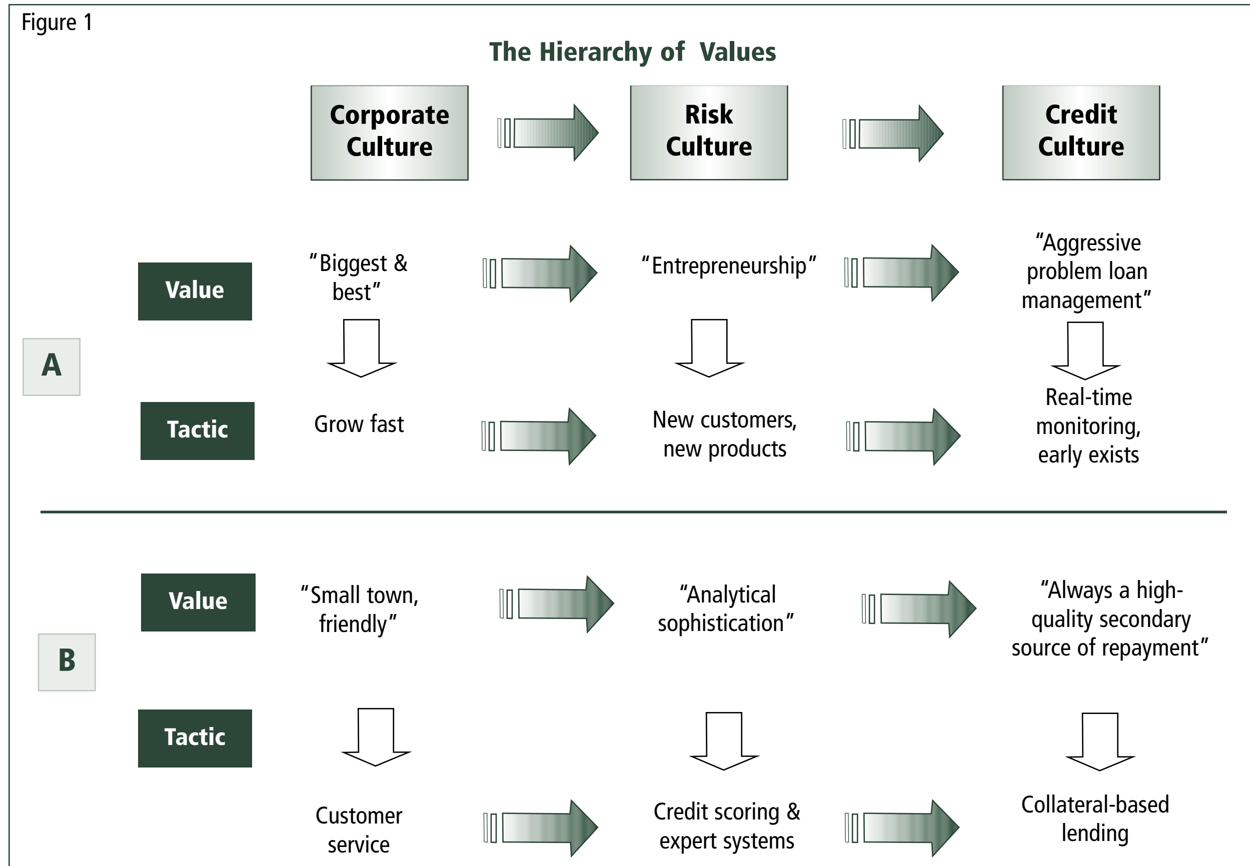
Culture Change for Dummies

Management 101 has a standard and perfectly fine approach to problem solving. Basically, there are three phases involved in problem solving of this sort:

- Phase I: Descriptive. Where am I? What is my present culture? What are the real values-in-use, the operating mentalities that drive actual transactions and decisions?
- Phase II: Diagnostic/Prescriptive. What should the culture look like? What are the values that should be first and foremost in the minds of the employees? Where are the major gaps between where I am and where I want to be?
- Phase III: Planning and Implementation. How do I actually change the way people think and act? How do we close the gaps? How do I get there? How do I get the rest of the organization to go along? Who gets to do what to whom for how long? How should I spend my time?

These phases are somewhat modular. That is, the institution can choose to do Phase I only or Phase II only. However, the launch of a Phase III program requires that Phases I and II have been accomplished—at the very least, vicariously.

So far, this is nothing more than codified common sense. However, it is seriously complicated by two realities. First, each phase is the subject of numerous frameworks and buzzwords. There is a rich menu of schools to choose from—"hard" versus "soft," people oriented versus systems oriented, top-down versus bottom-up, etc. There is only one other subject area within the management domain (strategic planning) that has more buzzwords per square inch than does *changing your culture*. Secondly, the phases will blur, overlap, and recycle. There's a social equivalent of Heisenberg's Uncertainty Principle at



work: The very act of describing a core value is likely to change the value. (A classic credit person will think differently once market and operating risk are seen to be embedded in every transaction.) The outside world—the source of the risks—will not stand still, and the target culture will morph into new forms during the process of defining and implementation.

Phase I: Description. Is there a problem? Sometimes, the issue is crystal clear—say, the SEC has issued a subpoena, your problem loans represent 50% of the outstandings, or you have $1 billion unexpected loss in Trading Operations, etc. The more interesting case study is when things are going well. To question "our collective values about risk" can be provocative, but there are ways around this. The first, best, and cheapest way of assessing values is to start with yourself; introspection is wonderfully instructive. But a culture involves collections of individuals, so you will need to involve others. Herein is a problem, because most of us have learned (the hard way) how difficult it is to understand the values of others.

At one end of the scale, you can hire a first-class PR firm to design questionnaires and interview multiple levels of employees using sophisticated, validated instruments, and statistics. At the other end, you can simply convene your, say, top 20 executives, give them the true/false quiz shown in the inset below, and discuss the results until you agree on a common set of answers. An excellent way to ensure an animated discussion is to assert that, in your opinion, all of the answers are "false." (A less confrontational discussion would ensue if you asked for responses on a 1-to-5 scale about "the extent to which you agree with the statement.") Warning: This exercise is best done with the help of a skilled outside facilitator.

Perhaps you have either a limited budget or little stomach for extensive confrontational meetings. Very well. Then simply watch the languages and behaviors of key decision makers in their natural habitats. For example, assume that, in the course of your daily routines, you overhear the following kinds of comments from account officers or credit administrators:

- "We're in the business of taking risks."
- "The agent bank has thoroughly analyzed the risks."
- "If we don't do it, Bank X will."
- "The parent won't let our borrower fail."
- "The ultimate source of repayment is refinancing."
- "Everybody's doing it. The fees are tremendous."
- "We can always get out if things go badly."
- "This loan can't lose."

Should you worry? I think so. Such thought patterns are the harbingers of unacceptably high loan losses. They also signal a risk culture with severe pathologies.

There is a multitude of commonsense techniques, ranging from highly sophisticated data-gathering efforts to simple observations absorbed through an

Mostly True or Mostly False

Categorize each of the following 10 statements as either "mostly true" or "mostly false." Do it quickly, based on your first impression. Assume that the statement refers to your own institution, but also note those items where you feel that your own institution may be unique on that particular item.

1. Genuinely strategic decisions (e.g., new products, acquisitions) are made with an appropriate degree of consideration for the risks involved.
2. Most of the officers in the institution have an appropriate level of understanding for how much risk appetite the company has for the particular product or customer set that they are responsible for.
3. Executive management (say, the top 10 officers) of the company can articulate clearly the company's risk vision.
4. Key line managers throughout the company have a uniform, simple, easily understood answer to the question from a shareholder at a cocktail party: "How much risk is the company taking?"
5. Unit-level plans and budgets include explicit risk targets as well as return targets.
6. Management is acutely aware of and pays extra attention to the risk potential imbedded in "stars," whether products, units, managers, channels, etc.
7. Lending units understand how their transactions and portfolios drive operating and market risk.
8. The CEO's values and views concerning risk taking generally are replicated down through the ranks.
9. Theoretical, technological, and mathematical sophistication is a necessary condition for having a strong risk management culture.
10. Formal risk analyses & periodic risk reports are integrated into pricing, performance evaluation, and planning systems.

MBWA (management by walking around) style. Choose the one that fits best your organizational style.

Phase II: Prescriptive/Diagnostic. What should the core values be? Contrary to best-selling consultants' books, there is no single answer. What we do know is that each institution must decide based on its own history, strategy, and style. But there *are* some useful principles.

The first suggestion is obvious to state but hard to put into practice. There should be direct, strong, and internally consistent linkages between the corporate, risk, and credit cultures. It is instructive to recall the definition of an airplane as "…. a set of spare parts flying in very close formation." A good culture (at any level) is one in which all of the organizational elements—credit policies, compensation systems, strategic goals, training programs, etc.—all "fit." Organizational literature refers to this as *alignment*. It—or the lack of it—is perhaps the single most important defining feature of a strong culture. (It is also important that the alignment is dedicated to the "right" values! One common banking example is to note that everybody is thoroughly aligned around *growth*, to such an extent that *quality* falls through the proverbial crack). Consider the chain-of-value statements shown in Figure 1 for two hypothetical institutions, A and B. Organization A is "in alignment"; the behaviors exhibited from top to bottom will be reinforcing and internally consistent. Organization B, on the other hand, is riddled with contradictions, and one would expect to see highly political sorts of behaviors. In both cases, however, values drive tactics and behaviors.

A GOOD CULTURE (AT ANY LEVEL) IS ONE IN WHICH ALL OF THE ORGANIZATIONAL ELEMENTS—CREDIT POLICIES, COMPENSATION SYSTEMS, STRATEGIC GOALS, TRAINING PROGRAMS, ETC.—ALL "FIT." ORGANIZATIONAL LITERATURE REFERS TO THIS AS *ALIGNMENT*.

The second suggestion is to recognize, accept, and finally exploit the reality that, except for the very small companies, there is no such thing as "the culture" of an organization; there is a welter of subcultures, each with distinctive values that imperfectly mirror the collective image. For example, in sessions aimed at deciding what values should be included in a bankwide risk vision statement, the following conflicts were encountered:

- The cross-functional task force charged with implementing the new enterprise-wide risk management system in conformity with emerging Basel II requirements wants a standardized, quantitative measure of "risk" down to the transactional level. Business units prefer operational, contextual measures.
- Trading units seek volatility and thrive on uncertainty. Credit Risk management despises volatility.
- The product manager wants to sell as many 30-year, fixed-rate, high-loan-to-value deals as she can. Treasury is worried about increasing interest rate risk beyond limits.
- The local branch manager seeks widespread market presence in his community. The Executive Office wants to shift to more of a focused, private banking strategy for upscale customers.
- The relationship manager wants to provide personalized high-touch, real-time service to valued customers. Operations is seeking to centralize, rationalize, and standardize back-office operations.
- The CEO wants to grow during difficult times. His motto is "When the going gets tough, the tough get going." The CFO wants to keep the company's AA credit rating. Her motto is "Murphy was an optimist."
- The head of the credit card portfolio wants thousands of standardized credit-scored loans. The manager of Structured Finance wants very few, very large, very customized loans.

We may seek understanding and an appreciation for other points of view, but "shared values" are going to be difficult to attain across broad job categories, except at a "motherhood" level. However, the process of meeting and seeking consensus (and disagreement) around values is invaluable, because the very process of inquiring about values shapes values.

Phase III and IV: Planning and Implementation. If you've gotten this far (and many firms don't, despite a full-fledged commitment to change),

you will have learned a lot about your institution and some of the key players. Surprisingly, much of the value of the change project will have been realized in getting to this point simply because you have involved people in self-inquiry. However, the byproduct of this inquiry is, in its simplest form, a gap analysis of two lists of core risk values—one describing where you are today, the second where you want to be. The inset at right is such a list derived from a three-month series of management meetings at a medium-sized bank. Now comes the really interesting challenge: How do you migrate from one to the other?

A critical choice must be made at this juncture—whether to adapt an evolutionary/incremental or a revolutionary/interventionist type of change strategy. The first tactic would focus on micro behaviors, tinkering, and nondramatic small steps. Generally, it's both slow and effective. The second tactic would be dramatic, unsettling to vested interests, and (usually) efficient. The choice, again, must reflect the organizational style, managerial preferences, and a number of other factors.

Two observations are probably safe:

- A variant of the evolutionary approach often becomes an interesting debate on how these newly identified core values should be expressed and communicated. Do we want a highly catchy "bumper sticker," a list of "five core beliefs," or a Lucite™ cube with each of its surfaces bearing a maxim for officer behavior? Marshall McLuhan was right: The Medium is the Message.
- "You can have it fast, cheap, or good. Pick any two." The moral of this experientially based aphorisms is that significant tradeoffs will be required.

Suppose you opt for the dramatic intervention, for which an identifiable project is created, resources are assigned, etc. How do you actually change the values? This question is the subject matter of three copious subliteratures—*change*, *leadership*, and *culture*. Even a brief search confined to just the last few years of the *The RMA Journal* will turn up dozens of relevant references, each with a particular slant.

It is an exquisitely managerial task—one that is enormously difficult but has the capacity to truly alter the course of the company far into the future. The following table is a vastly oversimplified checklist, an attempt to distill a few not-obviously-absurd ideas. These are expressed either as some generalized rules for managing a successful change project or—a very cynical adjunct—as reasons why you may not want to start.

Gap Analysis

Value Dimension	Today	Desired State
Loyalty	Unit	Bank-wide
Focus	Size, growth	Quality, profits
Risk taking	Aggressive	Conservative
Style	"Wing it"	Professional
Decision making	Make the #'s	Do what's right

The Good News:
We Know a Lot About How to Change Risk Cultures

- Focus on agendas and process, not structure or forms.
- Enlist and maintain the active support and involvement from the top down.
- Maintain an unrelenting focus on a few key values and vocabulary.
- Stay loose. Be prepared to adapt to changing views and circumstances.
- Create visible and continuous reinforcement of developing values.

Bad News: There are a Number of Reasons to Think Twice
Before Launching Such Projects

- It's hard to do.
- People will resist.
- It will entail painful decisions.
- It will take a long time.
- It will cost a lot.
- It will turn out differently than you intended.
- There will be collateral damage and unintended consequences.
- The vested interests will wear you out.
- It will probably fail.

HOFSTEDT'S LAW: THE LIKELIHOOD OF SUCCESS IN IMPLANTING A CULTURAL CHANGE IN A FINANCIAL INSTITUTION IS INVERSELY RELATED TO THE NUMBER OF MANAGERIAL LAYERS BETWEEN THE CEO AND THE TELLER AND DIRECTLY RELATED TO THE DEGREE OF CRISIS CURRENTLY PREVAILING.

In Conclusion

We accept the verdict of the past until the need for change cries out loudly enough to force upon us a choice between the comforts of further inertia and the irksomeness of action.

—Judge Learned Hand (1872—1961)

The culture of risk is always a key determinant of success or failure for a financial institution. It drives behavior. Therefore, management must periodically assess the state of the culture. That assessment should lead to explicit change efforts at intervals during the history of the firm. Some of those changes will be incremental/evolutionary rather than revolutionary. Others will be organic, even inadvertent, as the organization simply adapts to stimuli. Perhaps these less-obtrusive, everyday-tinkering kinds of adjustments will be the more powerful and long lasting—a testimonial to the "muddling-through" style of management. As Sherlock Holmes observed, "It has long been an axiom of mine that the little things are infinitely the most important."

However, there *are* times when more dramatic action is called for—a deliberate tampering with the business rationale and core values. These will test the leadership of the institution and have the potential to shape the future. ❒

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