

Risk Culture : A regulatory perspective

09 September 2010

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CULTURE | Why are regulators interested?

- Research post the 2001/02 crisis showed that the vast majority of insurance company insolvencies are preceded by either internal management or governance shortcomings or some external trigger events, or often a combination.
- “Unacceptable culture within firms was a major contributor to the financial crisis and so regulators should play a greater role in judging how culture drives firms’ behaviours and impacts on society as a whole.”
- “Even after all the supposed lessons learned exercises, we are still seeing some decisions by management in major firms that we would judge not to be prudent”
- “The end goal should be that firms understand their own culture and the potential risks posed by the wrong culture.”

– *Hector Sants, June 2010*

BUT WHAT DOES THIS MEAN IN PRACTICE? | Supervisory approach

- “Determining an ethical framework is for society as a whole, not an unelected regulatory agency. However, it is, I believe, our role to police behaviour and expect firms to have the right culture which facilitates the delivery of the outcomes we expect”
Hector Sants, June 2010
- To continue “to embed and fully implement the required cultural and organisational change that underpins our intensive supervisory agenda.”
- Outcomes-focussed supervision.
- Move from “old style” retrospective regulation where intervention occurred only when something went wrong to more proactive approach – intervening when FSA believes the results of a firm’s actions will pose a risk to its statutory objectives. (Is this really a fundamental shift?)
- “Inherently more confrontational and risky”, making difficult judgements.
- Are FSA supervisors equipped to be able to do this?
 - More supervisors
 - Sector teams
 - Prudential and conduct specialists
 - Risk team
 - More industry experience
 - Mystery shopping
 - On site visits
- More requests for information...
 - ... with more demanding and harder deadlines...
 - ... and less willingness to negotiate

BUT WHAT DOES THIS MEAN IN PRACTICE? | Supervisory approach

- More s166 reviews: during 2009, 56 Section 166 reports were issued by the FSA – of which 22% related exclusively to issues associated with corporate governance.
- 25% of critical issues highlighted by the FSA in recent ARROW risk mitigation programmes have related to issues of management, governance and culture, often provoked by strategic uncertainty on the part of senior management.
- Despite a Section 166 report being issued for a specific area, governance will be included, as it is seen as the control to prevent risk in many areas of the firm.
- Recent Section 166 reports have started to focus on individuals performing key roles.
- Skilled Persons increasingly being asked to comment on the competence, experience and skills of individual Board members.
- Strong focus on having appropriately skilled Non Executive Directors in place, with sufficient levels of time commitment to the role.
- Recent governance-related comments made by the FSA, following recent ARROW reviews have centred around :
 - The need for more competent NEDs;
 - Board effectiveness;
 - An inability to clearly formulate and articulate strategy.

BUT WHAT DOES THIS MEAN IN PRACTICE? | Supervisory approach

- But is there a coherent approach to culture?
- ... and how does a regulator measure culture?
- Focus for regulators is not to define one acceptable culture; rather regulators should focus on what an unacceptable culture looks like and what outcomes that drives.
- Hector Sants:
 - *“There must be a stronger and more explicit obligation to wider society. There must be clear recognition of the need for institutions to contribute to the common good.”*
- Regulators can intervene to ensure firms have the right cultures by:
 - Ensuring firms hire managers who act with integrity, by judging competency but also ensuring they understand the need to act with integrity, deliver the right culture and are equipped to do so
 - Ensuring firms have the right governance and behavioural framework to facilitate good judgement by their staff
 - Assessing the actions against society's wider expectations not just shareholder value

RISK CULTURE | So how can we evidence it to a regulator?

- The right judgements are made (outcome-based)
- Appropriate “tone from the top”:
 - Lead by example
 - Make examples – reward and punish
 - Right tone in regulatory interactions
- Clearly defined risk appetite, linked to a sustainable and well understood strategy.
- Formal governance processes
 - Committees, etc
 - Policies
- Three lines of defence – reflecting that first line identifies, manages, measures and reports risk
- Capability – quality and quantity of resource
- Effective systems and controls
- Relationship with others (shareholders, outsourcers)
- Role, impact and visibility of risk functions and senior risk people
- Formal involvement of risk in decision-making
- Evidence of challenge:
 - NEDs
 - Board
 - Executive
 - Risk
- How do you react when something goes wrong?
- Focus on evidence: MI, board papers, minutes
- Incentives, including remuneration
- Training and communication
- Constant reinforcement
- Common culture across a firm/group

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