

RISK CULTURE IN AUSTRALIAN BANKS:

Does size matter?

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Previous research has shown that the best risk outcomes are achieved when effective risk structures are combined with a favourable risk culture. We examine risk culture and staff perceptions of risk structures in five Australian banks using survey methods to investigate the influence of bank size. We find that size brings both advantages and disadvantages. The risk structures of large banks are perceived more favourably than those of small banks except for remuneration where the reverse is true. While all of the Australian banks assessed have a favourable risk culture, the large banks do better in two of the four dimensions of risk culture (proactive and manager) while small banks do better in another dimension (avoidance).

Until recently, 'soft' issues such as corporate culture were rarely mentioned by bankers or their regulators. However, practitioners and academics working in the economics, accounting and traditional finance fields are quickly having to learn about organisational behaviour, psychology and behavioural finance.

Contrary to the concerns of some, risk culture can be identified and assessed using robust psychometric methods. In the past few years much has been learned about risk culture and how it varies within and between financial institutions.

This paper examines risk culture in a group of Australian banks and how it varies with size. But first, it provides a quick review of how and why the 'risk culture' concept has become so important in modern financial institutions.

Following the global financial crisis in 2007-08 there was general agreement that risk management in banks had not been sufficiently prioritised relative to other competing priorities such as the drive for short-term profits. Since then, most banks have made radical changes to their risk management frameworks, policies and systems including:

- > the introduction of a 'three lines of defence model' under which all staff members have a role in risk management, including the risk takers
- > appointing a high-status Chief Risk Officer with direct access to the board of directors
- > an independent risk management function with expanded resourcing relative to the pre-crisis era
- > a risk appetite statement owned by the board of directors and cascaded appropriately throughout the organisation
- > better integrated risk management systems so that risk data can be aggregated across the organisation
- > training programs to ensure that all staff understand risk policies and their role in the risk management process
- > reforms to remuneration and performance measurement systems to ensure that rewards are allocated in a manner that supports prudent risk taking.

These risk structures should, at least in theory, help produce better behaviour by staff, i.e. a willingness to speak up and question business practices, compliance with policies, reporting of risk events, acting with a sense of accountability for risk, regular and constructive discussion of risk, and a lack of gaming behaviour. Ultimately, the right behaviour should result in superior risk

outcomes (higher risk-adjusted performance, fewer scandals and surprises). But the effectiveness of risk structures depends on the quality of implementation and also on the risk culture. If the risk culture is unfavourable, it may undermine the effectiveness of the structures as staff find ways to work around or ignore policies. For example, if the risk structures are perceived as mere window-dressing to satisfy regulatory requirements, staff will assume that they are not a genuine priority and act accordingly. Our research (Sheedy and Griffin, in press) has shown that for desirable risk behaviour to flourish, it is necessary to have both risk structures that are perceived as effective and a favourable risk culture. Put another way, the impact of risk structures is, to a large extent, felt through the risk culture.

So what do we mean by the term risk culture? It is defined as ‘the shared perceptions among employees of the relative priority given to risk management, including perceptions of the risk-related practices and behaviours that are expected, valued and supported’ (Sheedy et al. 2017).

A favourable risk culture simply means that risk management is valued/prioritised. It implies that staff understand what the risk appetite is and play their part in ensuring that the risk appetite is not breached.

Risk culture is only one particular facet of organisational culture — the aspect of organisational culture that is of most interest to prudential supervisors (Financial Stability Board 2014). Other facets of organisational culture — customer service culture, innovation culture, safety culture, ethical culture and performance culture — have also been studied. These focused or strategic cultures are the most effective for targeting particular outcomes of interest; for example, a customer service culture produces more satisfied customers and repeat business, a safety culture produces fewer and less serious accidents, and a risk culture helps ensure that the firm achieves its objectives and reduces surprises, scandals, and/or bailouts. Of course, no single organisation can have all of these strategic cultures; having many priorities means that they are not really priorities at all.

Risk culture is currently attracting considerable interest from industry, not least because of new regulatory requirements. Prudential standard CPS220 para. 13 states that:

The Board of an APRA-regulated institution is ultimately responsible for the institution’s risk management framework and is responsible for the oversight of its operation by management. In particular, the Board must ensure that: ... (b) it forms a view of the risk *culture* in the institution, and the extent to which that culture supports the ability of the institution to operate consistently within its risk appetite, identifies any desirable changes to the risk culture and ensures the institution takes steps to address those changes. (italics added)

Since January 2015 when this prudential standard was introduced, many directors and senior executives have pondered over this paragraph and how to implement the new standard. One common source of confusion relates to the distinction between risk culture and risk appetite (the amount of risk a firm is willing to take in order to meet its strategic objectives). A firm with a high risk appetite may enjoy great success if it has a favourable risk culture; conversely, a firm with low risk appetite might experience disastrous outcomes if it has an unfavourable risk culture.

A favourable risk culture simply means that risk management is valued/prioritised. It implies that staff understand what the risk appetite is and play their part in ensuring that the risk appetite is not breached. It implies a proactive approach to risk management i.e. risk is a consideration in all business decisions, staff have productive and regular discussions about risk, staff are encouraged to question the risk of business practices and identify new risks, and risk issues/breaches are not hidden but treated as a learning opportunity.

The aim of this paper is to shed light on the risk culture of Australian banks. We use the multi-dimensional Macquarie University Risk Culture Scale developed using a well-established framework and commonly accepted psychometric principles (Hinkin 1998). The procedure used for developing the scale, along with the evidence of reliability and validity is explained in Sheedy et al. 2017.

In particular, we investigate whether big banks have any significant advantage (or disadvantage) relative to smaller banks. While smaller banks may differ in terms of their mix of activities and, therefore, their risk appetite, this does not necessarily have any bearing on their risk culture as the two concepts are distinct. As risk culture is a new topic for scholarly investigation, there is little in the existing literature to guide us. To the extent that risk culture is a component of risk governance, we could extrapolate findings from previous governance research. Ellul and Yerramilli (2013) find that larger banks are more likely to implement risk governance. This is consistent with arguments based on economies of scale i.e. larger banks have more resources available to commit to risk management. They may also be subject to greater regulatory scrutiny due to 'too big to fail' concerns.

Method: Survey administration

Between July 2014 and July 2016 we assessed five Australian banks of which three are very large (drawn from the four major banks) and two are smaller. In some cases all staff were invited to participate while in others only a representative sample were invited to participate. In all cases the surveys assessed staff across all major business lines and all levels of seniority. Response rates varied between 21 per cent and 62 per cent. In total we received 8,921 individual survey responses of which 1,544 were from the smaller banks and 7,377 were from the big banks. Staff from all levels of the organisation participated, with some overrepresentation occurring of middle and senior managers and risk professionals.

The banks participated in the research on the basis that they would not be identified. Each bank received a confidential report containing our findings. It is interesting to see how perceptions of risk structures and risk culture vary within and between the banks.

Anonymous survey responses were collected via a secure online survey platform, with data only accessible by the university researchers. To encourage candour, employees were advised that their employer would receive only aggregated analysis of responses.

Each bank was asked to provide the researchers with access to a stratified sample of employees from multiple business units. The responses were drawn from 172 identifiable business units (66 from smaller banks and 106 from big banks).

Risks were defined as including: credit, operational (e.g. conduct, fraud, computer system failure, errors, loss of reputation, lawsuits), liquidity, underwriting and market.

The survey consisted of items answered on a six-point scale from 1 (strongly disagree) to 6 (strongly agree). To support the reliability of our measures (and hence the findings of the study) we report and analyse factor scores rather than relying on the results of individual survey items.

The process of validation for the Macquarie University Risk Culture Scale identified *four distinct factors of risk culture* (Sheedy et al. 2017). We therefore produce factor scores for business units and whole banks on each of the four identified factors of risk culture. Factor scores are created by taking a simple average of the scores for the three to six related items that comprise the factor (based on exploratory and confirmatory factor analyses in different organisations). The four factors are as follows:

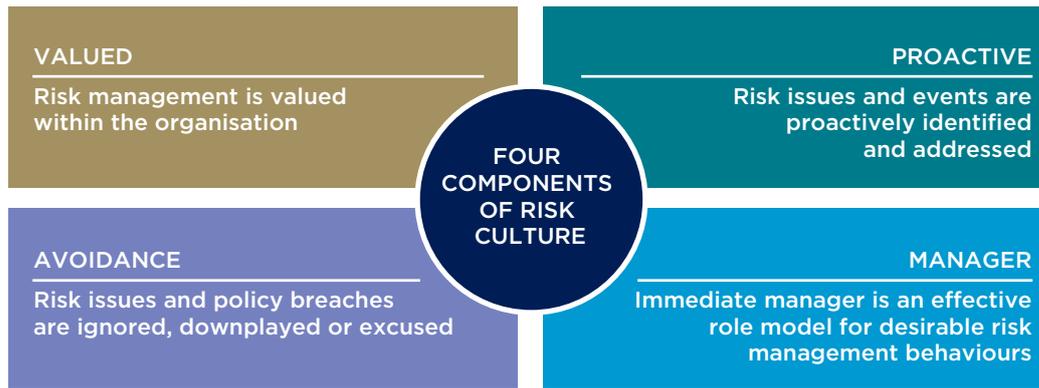
Valued: Staff perceive that risk management is genuinely valued within the organisation (e.g. 'Risk managers have authority and status in this organisation').

Proactive: Staff perceive that (in the local business unit) risk issues and events are proactively identified and addressed (e.g. 'For us, analysing risk events (including near misses) is very useful').

Avoidance: Staff perceive that risk issues and policy breaches are ignored, downplayed or excused in the organisation. (e.g. 'Senior leaders don't want to hear about bad news')

Manager: Staff perceive that their (local) manager is an effective role model for desirable risk management behaviours (e.g. 'When it comes to managing risk, my manager is an excellent role model of desirable behaviour').

FIGURE 1: Four components of risk culture



In addition to assessing risk culture, we used a similar approach to assess employee perceptions of risk structures on the following four dimensions:

Risk framework: perceptions regarding the effectiveness of policies, procedures, systems relating to risk (e.g. 'There is a strong level of expertise throughout the organisation with regard to risk management').

Risk managers: perceptions regarding the quality of specialist risk managers (e.g. 'The risk management teams have been integral to our business unit's performance').

Risk training: perceptions regarding the quality of internal risk training (e.g. 'The risk management training I have had in this organisation has given me a greater appreciation of risk issues').

Remuneration and KPIs: perceptions regarding the consistency of remuneration and performance measurement systems with prudent risk taking (e.g. 'Remuneration systems encourage staff to sometimes cross the line of acceptable behaviour (reverse coded)').

Analysis and discussion

a) Perceptions of risk structures

The perceptions of risk structures are favourable on most dimensions. Indeed for risk training, risk managers and risk framework the perceptions are favourable for every Australian bank we assessed.

How different are big banks from small banks? We found that staff in big banks perceive the risk frameworks and risk training more favourably than staff in smaller banks. Economies of scale in large banks may mean that bigger banks have been able to invest more in these crucial risk structures.

When it comes to remuneration and KPIs, the picture is reversed. Staff in small banks perceive the remuneration systems more favourably than staff in bigger banks. In each of the large banks we assessed, more than 50 per cent of staff have an unfavourable perception whereas in each of the small banks we assessed more than 50 per cent have a favourable perception. To clarify, favourable perceptions here relate to a sense that the remuneration and performance measurement systems support prudent risk taking and are unlikely to encourage staff to behave inappropriately. This may be because smaller banks are less likely to have bonus schemes that encourage short-term profit maximisation.

Staff in small banks perceive the remuneration systems more favourably than staff in bigger banks. In each of the large banks we assessed, more than 50 per cent of staff have an unfavourable perception whereas in each of the small banks we assessed more than 50 per cent have a favourable perception.

b) Risk culture

It's important to note that the risk culture of the Australian banks we assessed is favourable – there were no exceptions to this. That is, in every bank we have assessed, the average rating that staff give is in the favourable range and this applies across all four dimensions of risk culture. While we are not able to report individual bank results (for reasons of confidentiality) we can confirm that we observed some significant differences between them.

Table 1 provides regression analysis of the individual responses for the four dimensions of risk culture. Each column represents a separate regression where the dependent variable is one of the risk culture factors.

TABLE 1: Explaining individual perceptions of risk culture

	Avoidance	Valued	Proactive	Manager
Predictors				
Institutional	-0.12**	0.07	0.02	0.00
Wealth	-0.15**	-0.02	0.00	0.04
Risk/Audit	0.15**	-0.24**	0.15**	0.27**
Other HQ	0.13**	-0.11**	-0.09**	-0.04
Size (Small)	-0.39**	-0.02	-0.09**	-0.12**
Adjusted R ²	.034	.01	.02	.01
F	54.38**	15.08**	17.93**	23.67**

Note: Table 1 reports regression coefficients: *indicates significance at $p < .05$, **indicates significance at $p < .01$. Dependent variables are derived from survey responses. Staff may indicate agreement or disagreement to survey items according to a six-point scale, i.e. from strongly disagree (1) to strongly agree (6). From these responses factor scores are calculated for each individual as an average of related survey items. **Avoidance:** Risk issues and policy breaches are ignored, downplayed or excused; **Valued:** Risk management is genuinely valued within the organisation; **Proactive:** Risk issues and events are proactively identified and addressed; **Manager:** A role model of desirable behaviour. High scores are desirable except for Avoidance. Institutional, Risk/Audit, Wealth, Other HQ are dummy variables that indicate the business line to which the employee belongs (reference group is Retail/Commercial banking).

In terms of size, the small banks have significantly less favourable risk culture ratings than large banks in two dimensions (proactive and manager). Proactive captures a group of practices or perhaps a mindset where staff are on the front foot with regard to risk management. Staff are encouraged to anticipate risk rather than just react after the event. If a risk event occurs, it's treated as a useful learning experience rather than an exercise in blame and shame. Therefore, information about such events easily rises to higher levels and leaders respond in a supportive fashion, providing encouragement to those who have reported the problem. Discussions about risk are a natural part of all relevant business discussions because risk management is central to the business practice rather than an afterthought. Staff are encouraged to ask questions about risk policies and identify new risks. Those who do so are not treated as trouble-makers but partners in making the business more resilient. Compliance with risk policies and procedures is given high priority, even when the unit is behind on its performance targets.

The dimension where small banks significantly outperform their larger peers is in the avoidance dimension. In other words, staff in small banks are less likely to perceive that risk issues and policy breaches are ignored, downplayed or excused in the organisation.

The fact that big banks tend to outperform here is consistent with the earlier findings relating to risk structures. More effective risk frameworks and risk training may have helped staff better appreciate their role in the risk management process and the behaviour that is expected of them to make risk management successful. The consequence is that staff of large banks self-report more desirable risk behaviour such as speaking up.

The dimension where small banks significantly outperform their larger peers is in the avoidance dimension. In other words, staff in small banks are less likely to perceive that risk issues and policy breaches are ignored, downplayed or excused in the organisation. This dimension measures staff perceptions that the senior leaders only want to hear good news; i.e. they will shut their eyes to risk events or breaches of risk policy. When warning signs are received (i.e. evidence

that risk management is ineffective), leaders are likely to find some justification or explanation that will allow them to avoid addressing the issue. Staff are disinclined to report on problems in the risk management systems or signs that all is not as it should be due to the belief that such reports are likely to be ignored. Attitudes to risk management might be tokenistic, with risk management structures being undermined by frequent criticism, disdainful comments or neglect. As a result, staff are unclear regarding the firm's risk appetite and to what extent breaches will be tolerated. Staff receive mixed messages about the relative priority of risk management because of inconsistent implementation of policy e.g. non-compliance by star performers is sometimes excused. The consequence of less avoidance is less observed undesirable risk behaviour (manipulating risk controls, not taking risk seriously).

It is unclear exactly why smaller banks are typically doing better in the avoidance dimension. Perhaps in a smaller organisation staff have more regular contact with senior leaders and they feel more comfortable to pass issues up the line? Alternatively, staff might have greater visibility of the efforts of senior leaders to tackle issues. Staff in large firms may feel that the issues they raise vanish into the management hierarchy with insufficient feedback regarding the outcome.

We are often asked how risk culture varies according to business line (retail v. institutional v. wealth management v. head office functions). In this analysis the reference group is retail/commercial banking and the other business lines are reported relative to it. In the case of the institutional business line, it differs from retail/commercial only in terms of avoidance. If this is surprising, recall that risk culture is quite distinct from risk appetite. While the risks and the risk appetite might vary across business lines, risk culture will ideally be more consistent.

In the case of avoidance, institutional staff have a more favourable perception than their peers in retail/commercial (i.e. lower score) meaning that staff working in this business line are less likely to perceive that avoidance is a problem for the organisation. Perhaps this is because staff in the institutional bank feel more connected to the senior leaders? Exactly the same pattern is observed for wealth.

Turning to staff working in the second and third line of defence (risk and audit teams) we find that they perceive more avoidance and less 'valued' in the organisation – perhaps they have this more negative view of the organisation due to their unique role as monitors of risk management throughout the organisation. When reflecting on their own business units they have a more favourable view (significantly higher scores for proactive and manager). Once again, this is consistent with their special role and likely greater concern with matters relating to risk management. Staff working in other HQ roles (e.g. HR, legal, marketing and technology) have significantly less favourable perceptions on three dimensions (avoidance, valued and proactive).

It is worth mentioning that the adjusted R-squared values we report are low. This highlights that most of the variation in individual risk culture scores cannot be explained by this model. Significantly more variation is explained in (unreported) regressions that also include bank level differences and business unit differences.

On the subject of business units, we produced risk culture scores at the business unit level as well as at the bank level. In 95 per cent of cases we found agreement about culture at the local level (i.e. there is a statistical similarity¹ in the ratings given by people who work in the same business unit). In all but one bank we identified business units with culture significantly more or less favourable than the bank norm. In other words, each bank had subcultures that cannot be explained by differences in business line. Therefore, it is most likely that these differences result from variations in local management. Other researchers (e.g. Koene et al. 2002) have established that cultural differences emerge in local business units depending on the local leadership and other opinion leaders who set the tone. Interestingly, the bank with the greatest consistency of culture was a small bank suggesting that it may be easier to achieve consistency in a smaller organisation.

Conclusions

In summary, we find that:

- > The best risk outcomes are achieved when effective risk structures are combined with a favourable risk culture.
- > Staff of the big Australian banks tend to have more positive perceptions of risk structures than their peers in smaller banks. The exception to this is *remuneration* (staff of smaller banks are more likely to perceive remuneration favourably in terms of consistency with prudent risk taking).
- > Staff of the big Australian banks tend to have more favourable perceptions of their risk culture than those in small banks, especially with regard to *manager* (the perception that the local manager is a good role model of desirable risk behaviour) and *proactive* (the perception that risk issues and events are proactively identified and addressed). The exception to this is *avoidance* (the perception that risk issues and breaches are ignored, downplayed or excused in the organisation) where staff of smaller banks have more favourable perceptions of their risk culture.

Note

1. This similarity was measured using r_{wg} — the within group agreement index which is commonly used by psychologists for assessing similarity in ratings.

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