# Towards a more fundamental approach to Risk Management: Establishing a Safety and Fairness culture

*Speech by Theodor Kockelkoren, acting Chairman of the AFM, on the Global Risk Regulation Summit, 2nd of December 2013 in Amsterdam.*

***Introduction***

1. Banks are still in a tight spot. Since the crisis with an eerie regularity big issues, hitting basic values as safety and fairness, surface into the public eye leading to disbelief and anger within societies at large. Initially, the stability of banks was impaired to such an extent that taxpayers were forced to contribute significantly and now banks are being forced to invest substantially in strengthening their balance sheets. Subsequently, we have seen control issues within activities as diverse as trading, wealth management, product sales and anti-money laundering. This has forced banks to take either large losses or pay extensive fines or settlements. Perhaps even more importantly, this has sustained the anger and distrust towards banks currently still pervasive within society.
2. As a result, society has rewarded banks with a rising stream of regulations and requirements as well as enhanced, more intrusive or more intensive supervisory activities. Whether it is Basel III requirements to ensure the safety of banks and the system at large, increasingly stringent anti-money laundering requirements, increased regulations to ensure benchmarks are set in a fair and orderly fashion, or sharpened conduct of business requirements on advice and sales practices towards SMEs: banks can´t choose which to implement and which not, they have to properly comply with all these requirements. And rightly so, society is saying, having the unsafe and unfair behavior still freshly in mind.
3. This must be frustrating for banks. It is not as if they haven´t done anything since the crisis broke. They are pushing forward to implement the new wave of regulations properly. They are strengthening their balance sheets. They are rethinking broken business models. They are redesigning their practices to ensure customers are treated fairly. They still have quite some way to go – but important progress has been made.
4. So can we understand recent complaints by the banking industry that both the regulatory reform agenda as well as enhanced supervision is costing them dearly? Certainly. Implementing all regulations as well as properly responding to supervisors is a huge task and costs banks dearly. As recent as last week, we could read in the newspapers that the new

Frankfurt based Banking Supervisor would probably increase its reporting requirements as well as raise the total invoice send to banks for supervision: local banking supervision would not shrink as the ECB Banking supervision is being built up.

5. In the same week we were also able to hear politicians raise concern about the amount of new regulations. The concern is understandable. At the same time there is no simple answer, no apparent alternative. The simple answer that says we should reduce regulations does not address the big issues within the financial sector leaving society vulnerable. The simple answer that tries to persuade society to accept the massive risks of the financial sector as being part of nature will not work either.
6. There is a risk that the public discussion will be increasingly held in simple terms: on one side "Again something went wrong, let's increase regulations" and on the other "There is so much coming to the financial sector we should actually be careful to regulate it". Probably wisdom can be found in the middle ground. In order to find the just middle ground, I think it is important that we should be critical at the quality of regulations: can they reduce the symptoms they were designed for? But more importantly, we should invest substantially in coming up with cures for the fundamental flaws within the sector: the root causes of the harmful conduct we have witnessed.

***Biggest challenge for the industry is to create a safety and fairness culture***

7. I think that it is here where the biggest challenge for financial sector can be found: analyze thoroughly what is driving the harmful conduct and design approaches or interventions that will prevent fundamentally rather than instrumentally future damage. Indeed, most of the detailed regulations are instrumental. Most likely, in case of high quality regulations, they will effectively reduce or even take away the symptoms. However, most of the time they will not effectively address the root causes. I am saying this not to argue against instrumental approaches, but to argue for investing in finding fundamental approaches. As long as there are no proven cures for the fundamental ailments, we should continue to combat the symptoms using the instrumental approaches.
8. In some countries regulators have begun to explore the hypothesis that the culture of a financial institution, indeed of the sector as whole, is a critical factor determining behavior. Simply said the term culture is used to describe 'how things are getting done' beyond what is written in the procedures and implemented in the systems of the organization. It describes, among others, the attitudes and values of people. If these are not aligned with the

performance objectives of banks, for example treating customers fairly, a lot of control through procedures and bureaucracy within banks is necessary to ensure desired outcomes. I hope you will recognize that a parallel logic can be created on a sector level: if the values and attitudes of the sector are not aligned with the performance objectives of society a lot of control through regulations and supervision is necessary to keep the sector within the boundary conditions set out by society. I think with this hypothesis we are on to something highly relevant yet also rather complex and imprecise.

9. Let me take this hypothesis as a starting point for a more fundamental approach in redressing the issues of the financial sector. Thus the main challenge is first of all upon banks to build safety and fairness cultures – i.e. cultures that are aligned with the expectations of society. Secondly, regulators have a responsibility of stimulating and supporting institutions to embark on such a course.
10. I am sure there will be many people hearing this skeptical. Culture is soft. It can't be relevant. It is imprecise, it can't be reliably measured, let alone changed. This type of reasoning however smacks of the drunken man looking for his lost keys under the lamp post. Being asked why he keeps looking under the lamp post as the keys cannot be found there, he replies he lost the keys in the bushes further away – where there is no light. Indeed, culture is difficult to grasp and influence, but it may well be where some of the keys are.

***Based on experience in high hazard industries it seems feasible***

11. So, is it feasible? Already for a longer time in high hazard industries such as offshore, aviation, rail and petro-chemical industries a clear need has been recognized to move beyond implementing standards and control systems to manage compliance with those standards. Why? Because these more instrumental methods were seen to be effective but could not deliver the desired low level of incident rates. There was a clear recognition that in addition to standards and management systems, a culture needed to be created that naturally delivered superior safety results.
12. Over the years, maturity models were developed in order to determine to what extent a particular organization had developed practices and systems leading to a reliable organization. These models vary in detail but are in a broader sense very similar. Typically they comprise five stages. The first stage describes organizations typically not concerned with issues until major incidents happen. The second stages describe organizations focusing meeting technical standards, i.e. compliance oriented. In the third stage organization have

built elaborate management systems to ensure standards evolve appropriately using experience as the guiding motor. In the fourth and fifth stage organizations involve staff to be concerned with the outcomes of their own as well as team actions, ultimately leading to an organization where safety or another basic premise for doing business (such as treating customers fairly) is deeply engrained in the way business is done.

13. Few organizations seem to have reached the fifth stage, yet a considerable number of them is investing heavily in programs or concepts called 'Hearts and minds' or more prosaic, Safety Culture Maturity Model. They increasingly realize that methods aiming to develop safety cultures in addition to standards and management models are delivering lower incidence rates.
14. The financial sector could potentially learn valuable lessons from this experience. Generally speaking, it seems the financial sector is trying its best to become accomplished at the second maturity level. Looking at these other industries, indeed the discussion with the financial sector could benefit by moving on from 'more or less rules' to finding methods to establish safety and fairness cultures. This ought to be a discussion within each organization as well as on industry level. It seems the oil and gas industry has grasped this well as several organizations are making their own research and experience available to the industry. This behavior is based on the sound and solid belief that in their case safety ought to be integral part of doing business and cannot be traded against some other desirable objective.

***The AFM is increasingly engaging the industry to make the challenge a top priority***

15. What is the role of regulators? I think the first thing regulators should realize is that the relevance and feasibility of changing banking cultures to be better aligned with society is still more hypothesis than fact. As a consequence, regulators should avoid picking up the subject and discussing it normatively. The subject requires a subtle approach. This is underlined by experience showing one cannot change an organizational culture simply by coercion or by regulations. External pressure can be very conducive to changing a culture – but it is not sufficient. Regulators should be aware of the subtle adverse dynamics that occur when they start pressing too much for changing cultures of organizations. This does not mean we should not engage the industry on the topic.
16. Clearly, there are no clear solutions or obvious routes to be taken. Investing in knowledge is therefore paramount. But even more important is to create a climate where the topic can seriously and safely be discussed with top management. Their role is critical. If anything

comes out of all the academic research of changing organizations, it is that without a clear, visible and believable commitment from the top, no change program has much chance to succeed. The other point coming out of all the research is the need of a strong rationale for change ('burning platform'). Well, this is something I think that is clearly available.

17. What has the AFM been doing so far? Let me illustrate this with the 'Treating customers fairly' (in Dutch: Klantbelang Centraal) program. Since 2010 the AFM has employed a dual track approach in influencing the industry to treat their customers fairly. The first track started a year earlier in 2009 and consists of continuously building and applying a dashboard across the major players of the industry. The approach entails first of all to detail for each business area of banks what it actually means to treat customers fairly. Secondly, for each business area measurements are defined and taken to determine progress. Thirdly, these measurements are benchmarked between institutions as well as published, thus stimulating the industry to make haste as well as show society what progress is made. This approach is instrumental and for now effective: behavior in the measured areas is improving year by year. Relating to the earlier mentioned maturity models, it fosters a dynamic compliance culture stimulating organizations to move from the second to third stage – where compliance is pro-actively stimulated by all kinds of management systems.
18. The second track consists of influencing banks to change their organizations and especially their cultures so that the organizations naturally treat their customers fairly. This second track is considerably more difficult to make progress on. It is a track that the AFM is following since 2010. So we have some early experience. Let me share some of that with you.
19. In 2010 we started by asking banks and insurers whether they had an integrated change plan. With integrated we meant that it should include hard factors (such as organizational structure and KPI's) as well as soft factors (such as type of people one recruits and values that are fundamental to the business). Our hypothesis was (and is) that if you want to change organizations, you cannot just stop after redesigning the structure and possibly the incentive systems. In 2010 it was clear that banks and insurers needed to change in order to treat customers fairly. So the integrated change plans we were looking for, had to integrate the fair treatment of customers deeply into the organization.
20. Most banks and insurers were, with the past events in mind, committed to changing their organizations. It did not take very long before the remaining few banks and insurers felt the same commitment. The AFM assessed the change plans of the 10 biggest banks and insurers

especially in terms of completeness and thoroughness. We looked at products (and the way they were developed), performance measurement systems and the approaches how to recruit staff. The results showed significant variation: a couple of companies had no, whereas a few companies had well thought through integrated change plans – the rest being in between.

21. We saw most banks realized the severity of the decline in trust. As a result most banks had started programs with the aim to rebuild trust. At the same time, we found that many organizations just went in and started all kinds of programs without having analyzed the root causes thoroughly. Most often new product development and product review processes were part of the programs. Few organizations had clear performance indicators available for the top management team to follow progress and results in treating customers fairly. Most of the time top management relied on the Net Promotor Score (a variation on the customer satisfaction theme) to determine success in the area of treating customers fairly. Many times companies rewrote their missions and corporate values, but stopped just there instead of investing in an effective change program.
22. In 2011 we continued this approach, looking at the change programs as well as the speed of progress of these programs. Again we looked at the product development and review processes. We also looked again at the performance indicators as well as at the way new staff was recruited and existing staff was evaluated. It seemed in the area of product development performance of firms improved. Overall, there was still significant variation in performance across the industry.
23. In 2012 we focused again on the scope and structure of the change plans as well as the speed of the these plan. In addition, we looked more comprehensively how organizations are steered. For example, we determined the effectiveness of KPIs as well as how the KPIs worked and were used. Moreover, we also looked whether top management led by example. We looked at how management makes sure staff know what is meant by the principle 'Treating Customers Fairly'. Finally, we tried and are trying to understand whether a learning culture exists within the financial institutions. We focused on several aspects we think are certainly relevant: customer involvement, conduciveness of people to change, attitude to feedback, role of the non-executive board.
24. In 2013 we focused on the business model and the capabilities of organizations to change. Regarding the business model, we are for example determining whether companies feel a trade-off can be made between Treating Customers Fairly and commercial interests. It

seems that organizations that feel there is trade-off have a harder time implementing Treating Customers Fairly in their culture. In order to look at the change capabilities, we are building on the insights of 2012 when we looked at learning cultures.

25. In 2014 we will continue to invest in our understanding on how to establish safety and fairness cultures. We will also continue our discussion with industry in order to understand their efforts as well as stimulate them to give the subject sufficient priority. Although I just spent some time explaining what the AFM has done to stimulate that Treating Customers Fairly becomes engrained in industry culture, it should be clear that it is the prime responsibility of the industry itself to invest in this important subject. Preferably, they take the lead: sharing knowledge and experience, discussing the challenges with regulators (as well as society), and delivering results.

***Conclusion***

26. Let me finish by underlining the need for a dual track: we cannot and, looking at the experience elsewhere, should not abandon the more instrumental route of regulations, standards and compliance. Naturally, we should look critically at the regulations and standards: practices that can be improved ought to be improved, regulations that are not working should be avoided or deleted. Although important, this is I believe not the most critical task in front of us. What is paramount for industry and regulators alike, is to shape an industry culture that fits the views of society on the key topics of safety and fairness. I think this will contribute much more in limiting the level of regulations. Thus, putting it in different words, it is our task (industry and regulators) to move beyond the calculative, instrumental stage towards a stage where in addition to regulations and compliance management systems, safety and fairness cultures are established within the financial sector.