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## **Response of Reputability LLP to the Basel Committee on Banking Supervision consultation on Corporate Governance Guidelines for Banks, October 2014<sup>1</sup>**

### **Executive Summary**

1. Reputability is the leading consultancy for educating boards and senior leaders about behavioural and organisation risks and taking them on the steep learning curve to understand and tackle such risks. Reputability can deliver this effectively because of its unique blend of ground-breaking research, experience and expertise.
2. Behavioural and organisational risks lay at the root cause of the last banking and financial crisis, yet they are not recognised by classic risk management.
3. Other regulators have recognised the importance of behavioural and organisational risks. Their relative unfamiliarity to regulators and banks should be recognised in this cycle of revision of the Corporate Governance Guidelines for Banks published by the Basel Committee on Banking Supervision.
4. The current Guidelines reinforce the risk of suppressing 'learning cultures' and the prompt reporting of errors in favour of cultures that lead to the concealment of errors. The opportunity should be taken to ensure that banks adopt a learning culture such has been adopted with such striking success by commercial aviation globally.
5. We recommend amendments to the Guidelines in the Glossary and to paragraphs 28, 108 and 112.

## **About Reputability LLP**

Reputability is the leading consultancy for educating boards and senior leaders about behavioural and organisation risks and taking them on the steep learning curve to understand and tackle such risks. Reputability can deliver this effectively because of its unique blend of ground-breaking research, experience and expertise.

We welcome the opportunity to comment on the proposals of the Basel Committee Banking Supervision (“BCBS”) in this consultation, as regards behavioural, organisational and reputational risk issues.

We believe that if the corporate catastrophes of recent years, let alone months, have reinforced only one lesson, it is that most big problems ultimately emanate from board level, with human frailty in its many forms frequently a key factor in precipitating the crisis or tipping it into a disaster. These crises inflict huge losses on companies and governments alike.

Many have wondered why it was possible for multiple bank crises and collapses to happen despite the presence of hundreds of thousands of diligent, competent risk managers in the sector.

An important part of the reason is that the science of risk management had not, then, evolved far enough to bring behavioural and organisational risks, including those at or near board level, systematically under control. This gap was progressively recognised between 2011 and 2013, as the implications of ‘Roads to Ruin’, the Cass Business School report for Airmic and Reputability’s subsequent report, ‘Deconstructing failure – Insights for boards’, emerged. We provided 50% of the research team for the former and the entire team for the latter.

## **Introduction**

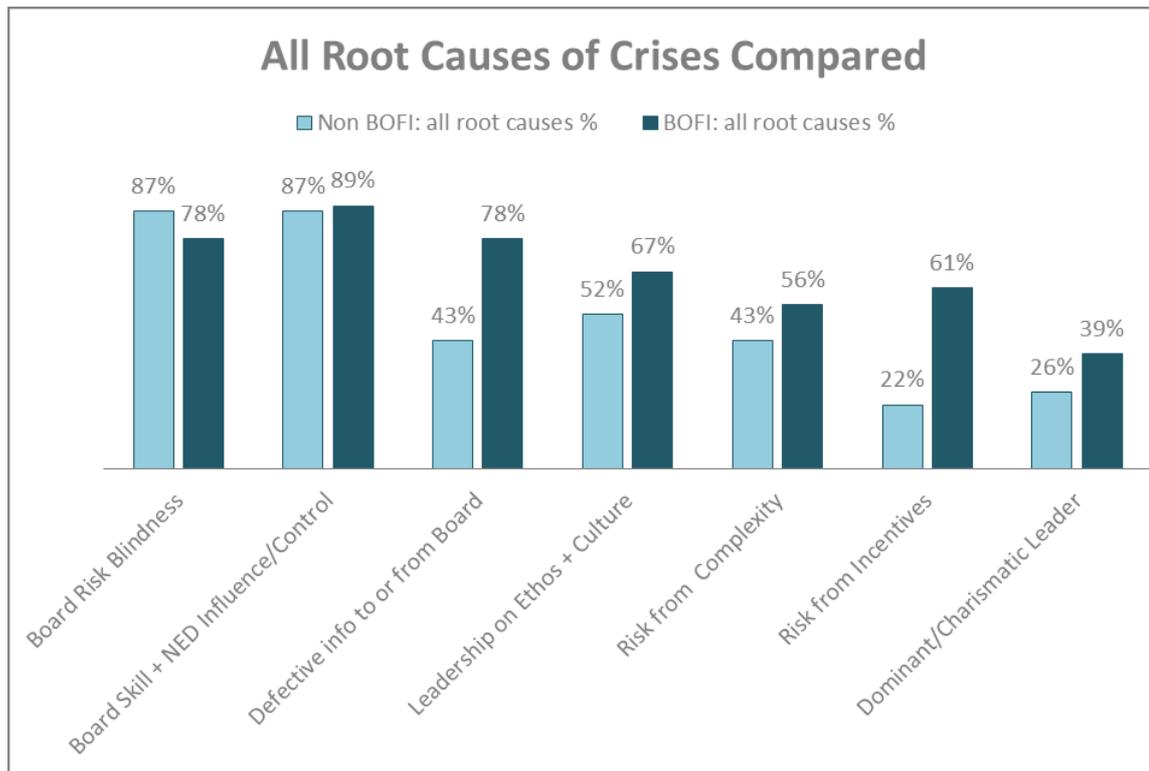
1. Since behavioural and organisational risks are not systematically recognised by classical risk analysis, they remain unmanaged and unnecessarily dangerous at all levels of organisations. The challenge, for regulators as much as for companies, is to find these risks and deal with them before they cause serious harm.
2. Many of the most important behavioural and organisational risks have their origins at very senior levels but the implications of this are not yet adequately recognised.
3. BCBS has long recognised operational risk and ‘unquantifiable’ risks. However the timing of its cycle of revisions of guidance has led it to fall behind on dealing with this issue.
4. The BCBS Principles for Sound Management of Operational Risk<sup>ii</sup> (2011) (“PSMOR”) defines Operational Risk as  
“the risk of loss resulting from inadequate or failed processes, people and systems or from external events. The definition includes legal risk but excludes strategic and reputational risk.”
5. PSMOR Principle 6 requires that senior management should ensure identification and assessment of operational risk to make sure all inherent risks and incentives are well understood.
6. PSMOR Article 39 suggests various tools but none of these focuses on the risks that stem from the fact that people run banks, let alone the risks from human behaviour at the highest (including board) level.
7. It is now widely accepted that the way people behave, individually or collectively, lies at the root cause of many, we believe most, major crises. The widely accepted terms for these risks are ‘behavioural risks’ and ‘organisational risks’. ‘Board risks’ are a subset of these. All are operational risks; and all are in principle capable of tipping a crisis into a reputational disaster.

## The Research on Behavioural and Organisational Risks

8. This is a research-based insight.
- a. Its origins can be traced back to Barry Turner's 'Man Made Disasters'<sup>iii</sup> (1978), Charles Perrow's 'Normal Accidents'<sup>iv</sup> (1984) and James Reason's 'Managing the risks of organisational accidents'<sup>v</sup> (1997)
  - b. The UK FSA's McDonnell Report<sup>vi</sup> (2002), on learning from crises at 21 European insurers concluded:

"Management problems appear to be the root cause of every failure or near failure, so more focus on underlying internal causes is needed"
  - c. 'Roads to Ruin'<sup>vii</sup> (2011) the Cass Business School report for Airmic studied 18 serious crises before cataloguing and illustrating 17 types of individual or organisational failure that underlay, or lay at the root cause of, the crises. Two of the four authors are members of Reputability's team.
    - i. 'Roads to Ruin' catalogued 17 types of 'underlying cause' into seven categories:
      1. Board skill and NED control risks – limitations on board competence and the ability of the Non-Executive Directors (NEDs) effectively to monitor and, if necessary, control the Executives.
      2. Board risk blindness – the failure of boards to engage with important risks, including risks to reputation and 'licence to operate', to the same degree that they engage with reward and opportunity.
      3. Poor leadership on ethos and culture
      4. Defective communication – risks arising from the defective flow of important information within the organisation, including to board-equivalent levels.
      5. Risks arising from excessive complexity.
      6. Risks arising from incentives – whether explicit or implicit.
      7. Risk 'Glass Ceilings' – arising from the inability of risk management and internal audit teams to report on risks originating from higher levels of their organisation's hierarchy.
    - ii. All are behavioural and organisational risk, frequently at board level.
    - iii. 'Roads to Ruin' also showed how these risks both caused crises and caused reputational damage.

- d. A follow-up report by Reputability LLP, 'Deconstructing failure – Insights for Boards'<sup>viii</sup> (2013) used a similar approach and extended the cohort of case studies to 41, including 12 banks and 6 insurers. Its focus was on the role of the board in failure. Its conclusions can be summarised in the following bar chart from Page 11 of 'Deconstructing failure'. ('BOFIs' means 'banks and insurance companies'):



- e. The UK's Parliamentary Commission on Banking Standards<sup>ix</sup> summed up its conclusions the underlying causes of the crisis in terms that included:
- i. "Banking history is littered with examples of manipulative conduct driven by misaligned incentives, of bank failures born of reckless, hubristic expansion and of unsustainable asset price bubbles cheered on by a consensus of self-interest or self-delusion. An important lesson of history is that bankers, regulators and politicians alike repeatedly fail to learn the lessons of history: this time, they say, it is different." (para 9)
  - ii. "Large banks still benefit from a significant implicit taxpayer guarantee as a result of their status of being too big to fail and too complex to resolve." (para 11)
  - iii. "The incentives for banks to become and remain too big and complex are largely still in place." (para 12)

- iv. “Excessive complexity in the major banks is not restricted to organisational structure” (para 13)
  - v. “The calculation of remuneration in investment banking and at the top of banks remains thoroughly dysfunctional.” (para 16)
  - vi. “Misconceived and poorly-targeted regulation has been a major contributory factor across the full range of banking standards failings.” (para 21)
  - vii. Shareholders are ill-equipped to hold bank boards to account. In particular, institutional shareholders have incentives to encourage directors to pursue high risk strategies in pursuit of short-term returns and ignore warnings about mis-selling.” (para 24)
  - viii. “The distorted incentives in banking are nowhere more apparent than in the asymmetry between the rewards for short-term success and costs of long-term failure for individuals.” (para 29)
- f. These are all examples of behavioural and organisational failings, though only a sub-set the range identified in ‘Roads to Ruin’.

## **Other regulators have recognised the importance of these risks**

9. The UK's Financial Reporting Council fully recognises the importance of what have become known as 'behavioural' and 'organisational' risks by specifically making them a part of UK boards' responsibilities:-
- a. The FRC 'Guidance on the Strategic Report'<sup>x</sup> recommends that boards disclose and describe 'Principal risks' "irrespective of how they are classified or whether they result from strategic decisions, operations, organisation or behaviour, or from external factors over which the board may have little or no direct control." (emphasis added)
  - b. The FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting'<sup>xi</sup>:-
    - i. Gives boards responsibility for "financial, operational, reputational, behavioural, organisational, third party, or external risks, such as market or regulatory risk, over which the board may have little or no direct control" (emphasis added);
    - ii. Is replete with references to particular behavioural and organisational risks that boards ought to consider;
    - iii. Recommends that a board:
      1. considers "whether it, and any committee or management group to which it delegates activities, has the necessary skills, knowledge, experience, authority and support to enable it to assess the risks the company faces and exercise its responsibilities effectively. Boards should consider specifically assessing this as part of their regular evaluations of their effectiveness", and
      2. should "satisfy itself that [its] sources of assurance [on risk] have sufficient authority, independence and expertise to enable them to provide objective information and advice to the board."
10. Insurance regulators have developed the Own Risk and Solvency Assessment ("ORSA") as part of insurer solvency requirements
- a. The USA's NAIC and the EU's EIOPA have made it clear that they intend ORSAs to identify and evaluate risks such as reputational, strategic and operational risks even though they can be hard to quantify.
    - i. As regards the European ORSA, 'operational risks' specifically include non-quantifiable risks in general, reputation risks, risks from organisational complexity, and

risks from human behaviour, whether individual or collective.

- ii. As to the USA, the NAIC guidance on the ORSA explicitly mentions complexity risk, and operational and reputational risks as examples of hard-to-quantify risks.
- b. In Consultation Paper 'CP26/14'<sup>xii</sup>, on the Senior Insurance Managers regime, reflecting the importance of skills in the leadership team, the absence of which is a risk, the UK's Prudential Regulation Authority proposes:
- i. At 2.4, "The proposed [regime] seeks to ensure that the senior persons who are effectively running insurers, or who have responsibility for other key functions at those firms, will behave with .... and skill."
  - ii. At 3.10, "Consistent with the expectation outlined in the approach document that 'the board should have a mix and balance of skills so that collectively it can understand the breadth of the business', along with the similar requirement in Solvency II, the PRA is likely to take into account the board's collective mix of skills and expertise when considering individual applications."

## **BCBS – The Current Position**

11. Whilst individual bank regulators (such as the PRA) may understand these risks and be making a start on responding to some of them, the Basel Committee's cycle of revisions has left it behind at least in terms of its Guidelines. So far as we have identified:-

- a. PSMOR makes:
  - i. no reference to behavioural risk
  - ii. one reference to organisational risk, in the context of organisational change
  - iii. reference to reputational risk, but mainly to exclude it from the definition of 'operational risks'.
- b. The Basel Committee's draft 'Corporate governance principles for banks':
  - i. Makes no reference to behavioural risk
  - ii. Refers to risks from organisation only in the context of change, silos and culture
  - iii. Recognises reputational risk only in the context of risk appetite, ethics, complexity
  - iv. States that risk identification and measurement should include both quantitative and qualitative elements. Banks should also have a method to identify and measure hard-to-quantify risks, such as reputation risk.

## Our Recommendations - Substance

12. We believe, and recommend, that the Basel Committee should take three steps.

- a. The Committee should recognise the evidence, that:
  - i. risks from the way people behave individually and collectively ('behavioural and organisational risks') lie at the root of a large proportion of failures within and outside the financial sector, being found wherever people are running organisations;
  - ii. the more senior the individual, the more influential they are: with the consequence that many of the most potent behavioural and organisational risks are those with their origins at or near board level;
  - iii. what 'Roads to Ruin' called 'risk glass ceilings' make it practically impossible for those below board level to police behavioural and organisational risks at senior levels in the organisation for fear of being sacked, whereas those at board level are not likely *voluntarily* to allow their activities, decisions or behaviour to be subject to risk analysis without a regulatory requirement to do so.
  - iv. cognitive biases prevent individuals and organisations from seeing their own shortcomings as outsiders would if they had access to the information to which insiders have access.
    1. Modern psychologists analyse the problem in terms of phenomena that lead us all to have a view of ourselves that may range from uni-dimensional to delusional. Where teams are involved, groupthink can play an important role. Technical terms they use in their dissection include cognitive dissonance, anchoring, self-serving bias, egocentric bias, confirmation bias, belief bias, framing, overconfidence and neglect of facts.
  - v. no application of 'Three Lines of Defence' ("TLD") can be better than the risk analysis that underpins it; with the consequence that the omission of behavioural, organisational and board risks from classical risk analysis means that TLD is equally defective.<sup>xiii</sup>
- b. The Committee should specifically bring behavioural and organisational risks including board risks within the range of risks to be surveyed by banks and supervised by supervisors, in a manner that:

- i. Makes it absolutely safe for risk professionals to delve into behavioural and organisational risks even if those risks originate from the firm's most senior leaders;
- ii. Makes it a requirement that boards undertake a dispassionate assessment, carried out by persons with appropriate expertise, of the extent to which those risks may be operating at all levels of the firm, including at its highest levels;
  - 1. Our experience is that making CROs answerable to boards is not sufficient. We have encountered CROs, NEDs and even Chairmen who appear reluctant even to raise such subjects with their CEO. We believe that a fear of reprisals or ostracism plays a significant part in this reluctance. We believe that CROs need explicit authority, derived from regulatory compulsion, to become effective as to these risks.
  - 2. There is also an issue of independence of those who carry out such assessments. Without robust independence, the analysis risks being watered down as a result of fear that future work or prospects will be damaged if the full truth is told to leaders. Such an analysis could provide a dangerous delusion to both the bank and its regulators.
- c. We believe that paragraph 28 last bullet point "ensuring that employees, including senior management, are aware that appropriate disciplinary or other actions will follow unacceptable behaviours and transgressions" requires revision to ensure that it does not stifle the voluntary reporting of errors and a culture which enables an organisation to learn from errors that do not have severe adverse consequences.
  - i. There is a considerable literature<sup>xiv</sup> on the 'just culture' that keeps aviation safe. The UK Civil Aviation Authority definition of the 'Just Culture' states<sup>xv</sup>:
    - 1. Individuals are not punished for actions, omissions or decisions taken by them that are commensurate with their experience and training but which result in a reportable event; but
    - 2. Gross negligence, willful violations and destructive acts are not tolerated.

## Our Recommendations – Amendments to the BCBS Draft

13. We recommend that the BCBS makes the following revisions to its consultation draft dated October 2014. **We have indicated revised words in red.**

- a. In the glossary, add a definition of Risk that specifically includes behavioural, organisational, board, reputational and other hard-to-quantify risks:
  - i. **“Risk: Risk includes hard-to-quantify risks such as behavioural, organisational and reputational risks and includes risks from all levels of the firm right up to and including board level.”**
- b. Amend Paragraph 28, last bullet point, to read:
  - i. ensuring that employees, including senior management, are aware that **whilst those who admit to inadvertent errors and failings before adverse consequences emerge will not be punished**, appropriate disciplinary or other actions will follow **unacceptable** behaviours and transgressions **that are grossly negligent, reckless, willful or deliberate**
- c. Amend Paragraph 108 to read:
  - i. The CRO should have the organisational stature, authority and the necessary skills to oversee the bank’s risk management activities **including skills and explicit authority as to behavioural and organisational risks from the bottom to the very top of the organisation**. The CRO should be independent and have duties distinct from other executive functions. .... While formal reporting lines may vary across banks, the CRO should report and have direct access to the board or its risk committee without impediment. The CRO should have the ability to engage with the **Chairman, the** board and with senior management on key risk issues **including risks at board level**. Interaction between the CRO and the **Chairman,** board and/or risk committee should occur regularly, and the CRO should have the ability to meet with the **Chairman,** board or risk committee without executive directors being present.

d. Amend Paragraph 112 to read:

- i. Risk identification and measurement should include both quantitative and qualitative elements. Risk measurements should also include qualitative, bank-wide views of risk relative to the bank's external operating environment. Banks should also have a method to identify and ~~measure~~ evaluate hard-to-quantify risks, such as behavioural, organisational and reputational risk. Boards should ensure that behavioural and organisational risks at or near board level are objectively evaluated by experts with the authority and experience to ensure that such evaluations are credible and robust and the independence to ensure that any unwelcome insights are delivered to the firm and its leaders undiluted by any fear of reprisals.

## Conclusion

14. We thank the Basel Committee on Banking Supervision for the opportunity to comment on their Consultation and will be happy to respond to questions arising.

## ENDNOTES

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- <sup>i</sup> <http://www.bis.org/publ/bcbs294.pdf>
- <sup>ii</sup> <http://www.bis.org/publ/bcbs195.pdf>
- <sup>iii</sup> 2nd edition ISBN 0 7506 2087 0
- <sup>iv</sup> 2<sup>nd</sup> edition ISBN 0-691-00412-9
- <sup>v</sup> ISBN 978 1 84014 105 4
- <sup>vi</sup> [www.fsa.gov.uk/pubs/occpapers/op20.pdf](http://www.fsa.gov.uk/pubs/occpapers/op20.pdf)
- <sup>vii</sup> [http://www.reputability.co.uk/files/press/Roads\\_to\\_Ruin\\_The\\_Analysis.pdf](http://www.reputability.co.uk/files/press/Roads_to_Ruin_The_Analysis.pdf) Full report with case studies available on request
- <sup>viii</sup> <http://www.reputability.co.uk/files/press/Deconstructing-failure.pdf>
- <sup>ix</sup> <http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbcs/27/2702.htm>
- <sup>x</sup> <https://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Clear-and-Concise-Reporting/Guidance-on-the-Strategic-Report.aspx>
- <sup>xi</sup> <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Control-and.pdf>
- <sup>xii</sup> <http://www.bankofengland.co.uk/prs/Pages/publications/cp/2014/cp2614.aspx>
- <sup>xiii</sup> <http://reputabilityblog.blogspot.co.uk/2013/09/three-lines-of-defence-dangerous.html>
- <sup>xiv</sup> For one example among many, [http://flightsafety.org/files/just\\_culture.pdf](http://flightsafety.org/files/just_culture.pdf)
- <sup>xv</sup> <http://www.caa.co.uk/application.aspx?appid=7&mode=detail&nid=1975>