Which is the fairest firm of all?

Jakob de Haan and Wijnand Nuijts explain why the Netherlands financial supervisor decided to expand its oversight of financial services firms by holding up a mirror to ethics and they discuss the impact this has had on Dutch firms

After the Global Financial Crisis, public trust in banks took a pounding. Although that trust has recovered somewhat since then, worldwide the financial sector remains the least trusted according to the Edelman Trust Barometer. That is a problem for several reasons.

One, low trust in the sector may undermine financial stability. In the worst case, it may even lead to bank runs. Two, low trust may also damage the financial services industry and, with it, the wider economy. If the industry is not trusted, consumers will engage less. That means less business for financial services firms and, in turn, reduced availability of capital for productive purposes.

It is important to remember that trust in financial institutions depends on the behaviour of these institutions. Academic studies show that prudent behaviour, which is characterised by a long-term focus that takes into account the interests of all stakeholders – as opposed to short-term profit maximisation – has a positive effect on consumers' trust.

The role of financial supervisors

Although trust is ultimately generated by firms themselves, its importance suggests that financial supervisors should be mindful of fostering it. After all, the role of financial regulation is to safeguard the financial stability both of individual firms and of the sector as a whole. Today's undesirable behaviour at financial institutions is tomorrow's solvency and liquidity problem.

Even when the numbers suggest that a firm's continuity is not compromised, its corporate culture and behaviour may pose risks to that continuity. Research on board effectiveness shows, for instance, that supportive leadership styles and constructive debate between board members are important for good performance. Other research suggests that there is a relationship between organisational culture at a firm and the level of risk.

The policy of De Nederlandsche Bank

In April 2010, De Nederlandsche Bank (DNB), which is the financial supervisor in the Netherlands, was the first central bank to give the go-ahead for the development of the supervision of behaviour and culture at financial institutions. That ground-breaking policy was based on a paper first published in 2009: "The Seven Elements of an Ethical Culture". DNB emphasised the importance of balanced decision-making aimed at reconciling the conflicting interests of various stakeholders. It also highlighted the role of leadership and constructive challenge in that process.

Constructive challenge means a critical and investigative debate between board members in which diverse perspectives and situations, and their consequences and risks, are explored. But DNB's study also recognised that the quality of the challenge might be hampered by behaviour such as group conformity. The desire to reach consensus can restrict diverse opinions.

A new departure in bank supervision

In contrast to "traditional" supervision, behaviour and culture supervision is not about quantitative analysis. It uses qualitative methods taken from social and organisational psychology to determine behavioural patterns that are less tangible than financial indicators. Culture and behaviour can be compared to an iceberg. Looking at the tip of the iceberg gives you no idea of what is underneath. Most of what matters is out of sight.

DNB's approach distinguishes between three layers in a firm's culture: behaviour; group dynamics and behavioural patterns; and mindset. The deepest level of culture in this model is mindset. It refers to deep-rooted convictions and values. An individual's mindset determines how they view the world. It helps them decide who is reliable and who is not, and what has priority or importance.

Group dynamics refers to the underlying relationships between and among executives. Is the atmosphere conducive to board members calling each other to account for adverse behaviour? Is it one of collaboration, or of competition?

The third layer of culture, behaviour, is the most visible. DNB pays particular attention to behaviour regarding decision-making, leadership and communication. The essential question it asks as a supervisor is whether the behaviour seen in these three processes contributes to a firm's sound and ethical business operations and reduces its risk profile.

Ten years of holding up a mirror to behaviour

DNB was the first supervisory authority to target culture and behaviour as risk factors, and the first to incorporate this aspect in its supervision. So, what has it seen over the past decade?

It aims to identify behavioural patterns that may jeopardise the financial position, risk profile and integrity of financial institutions. In other words, supervisory authorities hold up a mirror to institutional behaviour and culture and draw executives' attention to the potential risks that arise from them.

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Since April 2011, DNB has conducted approximately 100 studies into behaviour and culture within banks, insurers, pension funds and trust offices, both in the Netherlands and abroad, using methods it has developed itself. These studies have yielded a wealth of findings on board effectiveness, change capacity, risk culture and ethical culture. Each of the examinations resulted in institution-specific findings, which are confidential, but we can share some general results.

It's the barrel, not the apples

DNB recently adopted a tool to try to identify behavioural patterns that could lead to misconduct before problems occur. It focuses on the root behavioural and cultural causes of misconduct at team level. Unethical behaviour is not considered a matter of individual "rotten apples". Instead, the DNB approach is based on the premise that individuals act in accordance with cultural values they receive from the environment in which they work. In other words, unethical behaviour largely depends on the barrel, not the apples.

What sort of culture can encourage misconduct? Results show that misconduct takes root more easily in the context of overambitious and/or unrealistic strategies, where objectives and decisions are focused on the short term and where priority is given to profit and/or growth at the expense of risk management and compliance. These ambitions may create an organisational climate in which individuals and teams are cautious to voice dissent, or even an alternative viewpoint.

That is especially the case where there is no psychological safety. Psychological safety exists when someone can speak out without fear of negative personal repercussions. As such, psychological safety is an "enabler" for denouncing unwanted behaviour. But firms need more than psychological safety to protect their integrity.

The way a company deals with errors can also be corrosive to good conduct. Many financial institutions react to mistakes by punishing those who have committed them or by failing to address them at all. Both approaches prevent organisational learning and may, therefore, set the scene for further bad behaviour.

Measuring integrity

The climate of integrity at firms is measured to find answers to the following questions:

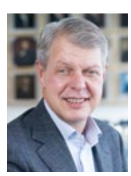
1. What is the underlying mindset of the board and how does this influence the firm's objectives? Are these objectives realistic?
2. What is the degree of constructive challenge in a firm and to what extent is this encouraged (or not encouraged) by leadership, social norms and psychological safety?
3. How does a firm deal with errors? Does it learn from unintentional mistakes and is unacceptable behaviour addressed according to its severity and culpability?

To answer these questions, DNB uses a broad spectrum of quantitative and qualitative instruments, such as desk research, surveys, interviews, self-assessments and observations. Through data analysis and triangulation, it is possible to identify the underlying behavioural pathways. The approach is broad and aims to identify all possible root causes of misconduct, regardless of whether they arise from the organisational culture, structure or environmental factors.

Taking a hard look

To restore public confidence in financial institutions, financial services firms need to change some aspects of their businesses, including organisational behaviour and culture. But these changes require time and patience and a hard look in the mirror.

Change for the better starts with supervisors making executives aware of potential problems and making them willing to act. That triggers what may prove to be a prolonged trajectory of change at the organisation. DNB's experience is that most financial institutions that have been assessed follow up on the assessment on their own initiative. Providing a mirror apparently helps. ■



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