Incentives, Risk Culture and Compliance

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Balancing
Profit v. Compliance

These days all finance professionals are considered to be risk managers.

Risk duties:
- Compliance with risk policy
- Speaking up/challenging
- Identifying new risks
- Taking responsibility
- Etc.

How do incentives and risk culture fit in to the balancing act?

What is Risk Culture?

‘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’

Why? Governance/policies/controls alone are not sufficient.

Espoused vs Enacted.

Not risk appetite, not risk structures, not behaviour per se.

Risks: Credit, Operational (includes cyber, AML), Liquidity, Misconduct, Reputational etc.

Risk culture

Safety culture

Service culture

Innovation culture

Ethical culture

Sales culture

All facets of organisational culture!!

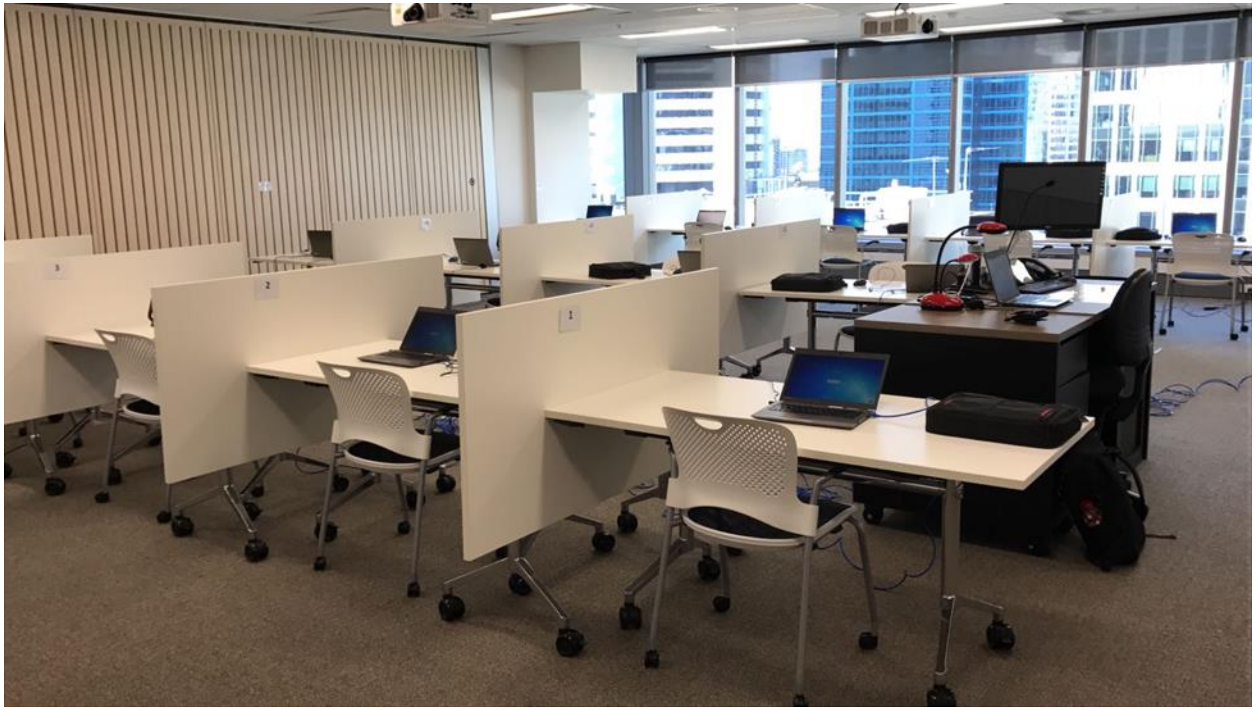
Components of Risk Culture

EACH 3-6 SURVEY ITEMS

Sheedy, Griffin, and Barbour. (2017) "A framework and measure for examining risk climate in financial institutions." *Journal of Business and Psychology* 32(1): 101-16.

Experimental Study

CONTROLLED ENVIRONMENT



303 finance professionals (recruited through FINSIA) came to city lab in May 2017. We guaranteed everyone a minimum of $50 for a one hour session with the potential to earn up to $200, payable in cash at the end of the lab session. In the end, average participant payment was $115.

Can we better understand how culture, incentives and compliance are related?

- 3x2 between subjects methodology

Framing (manager/peer behaviour)	Risk Focus	Nil	Profit Focus
Fixed payment.			
Incentive payments based on **total expected value** of investments			

Control for gender, age, seniority, tenure, personal attitudes…

Subjects assess up to 60 deals in 20 minutes.

Your job is to make as many investments as possible, provided they comply with limits

Risk limit in place; 20 of the 60 deals violate limits.
Audit rate = 20%.
Penalties for non-compliance apply.

An Example

INCENTIVE PAYMENTS, INVESTMENT 1

2 possible outcomes for the investment:

- Chance of profit = 60% Profit amount = $200,000
- Chance of loss = 40% Loss amount = **$250,000**

Expected profit = 60% x 200,000 - 40% x 250,000 = $20,000
Cash payment = 0.023% of (total expected profits less any penalties)
Risk limit (expressed in terms of Loss amount) = **$200,000**
Penalty for non-compliance (if caught) is 3x expected profit
Audit rate = 20%

Would you invest?

An Example

INVESTMENT 1

So the overall expected value on the deal: \$16,000 - \$8,000 = \$8,000

Not caught

80% chance of \$20,000 = \$16,000

Caught

20% chance of \$20,000 less penalty of \$60,000 = 0.2 x (\$20,000-\$60,000) = -\$8,000

Would you invest?

Situational Cues/Framing

PROFIT FOCUS

In your workplace compliance with risk policy seems to have a **low priority** compared with meeting profit targets. Non-compliance is common. Your manager rarely mentions the risk policy but talks often about the need to meet budget. He is always giving you motivational messages to encourage you to boost profits. You notice that colleagues who breach policy are **excused** if they are top performers. The risk policies are often **criticised** by staff because they can interfere with meeting profit targets; risk managers have **low status** compared with people who have great profit figures.

Situational Cues/Framing

RISK FOCUS

In your workplace non-compliance with **risk policy is taken very seriously** and is extremely rare. Breaches are not excused or tolerated, even if they produce high profits. Your manager is an excellent role model of risk management behaviour and talks frequently about the **need to comply with risk policy**, even when the team is behind on profit targets. It is clear from what colleagues do and say that compliance with risk policy is regarded as essential for the firm to survive and prosper. **Risk managers are highly respected** because they are seen as adding value to the organisation.

Perception Question

A MEASURE OF RISK CULTURE (AFTER EXPERIMENT)

In the experiment you just completed, a number of investments were outside of risk policy because the Loss Amount exceeded $200,000.

In your opinion, what percentage of participants in the experiment would ALWAYS follow risk policy (i.e. not invest if outside the risk policy)? (Enter X%)

Higher percentage indicates more favourable risk culture

Lower percentage indicates less favourable risk culture

Some Findings

WHERE'S THE INCENTIVES TRADEOFF?

	Group 1 Fixed Payment, No Framing	**Group 2** Incentive Payment, No Framing
a. **Number** of Participants	51	52
b. Average number of investments	28.4	30.3
c. Compliance rate by Person.	68.6%	42.3%
d. Compliance rate by Deal.	85.9%	78.4%
e. Perceptions of Compliance.	81.9%	65.0%

Some Findings

ROLE OF MANAGER/CO-WORKER SIGNALS

	Group 1 Fixed Payment, No Framing	**Group 2** Incentive Payment, No Framing	**Group 3** Fixed Payment, Profit Framing	**Group 4** Incentive Payment, Profit Framing	**Group 5** Incentive Payment, Risk Framing
a. Number of Participants	51	52	51	50	65
b. Average total investments	28.4	30.3	31.0	32.3	30.5
c. Compliance rate by Person.	68.6%	42.3%	60.8%	38.0%	55.4%
d. Compliance rate by Deal.	85.9%	**78.4%**	85.3%	**63.7%**	**82.9%**
e. Perceptions of Compliance.	81.9%	65.0%	68.2%	57.3%	68.0%

Some Findings

TIREDNESS AND COMPLIANCE?

	Group 4 Incentive Payment, Profit Framing	**Group 6** Incentive Payment, Profit Framing, No Calculations
a. **Number** of Participants	50	34
b. Average total investments	32.3	41.2
c. Compliance rate by Person.	38.0%	35.3%
d. Compliance rate by Deal.	**63.7%**	**72.7%**
e. Perceptions of Compliance.	57.3%	45.4%

Conclusion

Risk culture is an important determinant of compliance behaviour which is in turn effected by incentives and the behaviour of managers/co-workers. When managers/co-workers are profit-focused, and when incentives are linked to profits, rates of compliance fall. The effect is felt via risk culture.

Other Explanatory Variables

Variable	Impact on Compliance From Regression Analysis
Individual Age	No impact
Individual Gender	No impact
Time in Australia	No impact
Industry Tenure	Longer tenure was associated with **more** compliance.
Seniority	No impact
Lines of Defence	No impact
Segment	Those working in superannuation were significantly **less** likely to comply.
Gross Income	No impact

Other Explanatory Variables

Variable	Impact on Compliance Based on Regression Analysis
Individual Risk Tolerance (Financial)	No impact
Individual Attitude to Risk Management and Compliance	Those with favourable attitudes to risk/compliance were significantly **more** likely to comply.
Individual Personality (Conscientiousness)	No impact
Workplace Culture in the real world (Avoidance)	No impact

Where to next?

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More experiments can be designed to:

- Understand how to improve incentive design
- Understand how to improve risk/ethical culture
- Understand how/whether 'Executive Accountability' regimes work
- Or……

Big advantages in testing in the lab before going to the field, but this kind of research is expensive.

1. **Is this the kind of research that the industry values?**
2. **Who will pay for it?**

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Questions?

LinkIn for regular research updates