



# An Interview with Professor Kristen Jaconi

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**Q:** Regulators have emphasized the importance of organizational culture as both a risk factor in itself and as an instrumental element of any successful risk management program. What are your views?

**A:** When I joined the University of Southern California Marshall School of Business faculty in 2018 to teach enterprise risk management and to run what is now the Peter Arkley Institute for Risk Management, I did not appreciate the importance of culture to effective risk management.



While consulting at Promontory Financial Group, I saw that prudential regulators had started to concentrate on culture. I remember vividly the then-Federal Reserve Bank of New York President and Chief Executive Officer Bill Dudley's [industry-scathing speech on the reference rate submission scandal](#), delivered in fall 2014, followed by an [even more industry-scathing speech on culture](#) a couple weeks later. That latter speech launched the FRBNY's *Workshop on Reforming Culture and Behavior in the Financial Services Industry* and a "culture" initiative that continues to this day.

In the wake of this new focus on culture, banking clients would frequently seek guidance on the best metrics to measure a sound culture. I struggled as a consultant to respond meaningfully and thoughtfully. Did I, like Bill Dudley and several others, think that (weak) culture was the common link between the 2007-2008 financial crisis, the reference rate submissions scandal, the London Whale scandal, the recurrent sanctions violations? I don't think I knew.

**"Caring" about risk is where I see the palpable difference between the cultures of the banks and the non-banking entities that I've encountered.**

I had spent nearly a decade consulting for financial institutions, helping them institute what we would call "best-of-class" enterprise risk management programs, or at least aiming them towards that goal with the right governance with the three lines of defense framework; the right board committees; the right management committees; the right executive officers with all with the right roles and responsibilities; the right documentation with the right risk appetite statements and a seemingly infinite number of the right risk management policies; the right quality and the right quantity of staff; the right information technology systems (or at least aspiring to get there) and the right governance, risk and compliance tools; the right communications apparatus with internal and external stakeholders; the right monitoring and reporting framework aiming to collect and clean the right data.

And what would happen to these institutions with these nearly perfect risk management programs? They would often fail in managing their risks in some way and, often enough, they failed badly. How could this be? After all, they had all the "right" elements in place...

In fall 2018, I began to understand the significant role culture plays in effective risk management. As I started to teach risk management classes at USC, engaging risk management personnel in non-banking industries in Southern California to speak in my classes, I noticed that these individuals seemed to care deeply about risks and risk management. Their organizations seemed to have more effective risk management than the banking industry but with limited governance: no board-level risk committee; no management-level risk committee; no chief risk officer; limited risk documentation and no risk appetite statements; limited staffing — sometimes just one or two individuals; sometimes a GRC tool or two; an unsophisticated communications apparatus with stakeholders; basic monitoring and reporting but no enterprise-wide risk reporting; no chief data officer; no data quality standards. In reality, not much of anything compared to the large banking institutions. And their budgets paled in comparison to the hundreds of millions of dollars the largest financial institutions spend on risk management each year.

But what did these organizations have in abundance? Culture. Not only a risk-aware culture, but also what I'd call a "risk-caring culture." After 20 years consulting, policy-making, and lawyering in banking and the capital markets, I realized in my first 18 months in academia that this costly and complicated three lines of defense we had built up at our banking institutions are mere Maginot lines without a risk-caring culture to buttress them.

**Q:** Let me draw you out on that term, “a risk-caring culture.” We often hear reference to a “culture of compliance” or a firm’s “risk culture.” I’m not sure the use of these terms is very well thought-through, and I suspect that different people may use these terms to mean different things, so we’re not communicating effectively. What do you mean with your term?

**A:** That’s right. For example, policy-makers, regulators, academics, consultants have been focused on the notion of a “risk-aware culture” for several years now. Being aware of the risk, or identifying the risk, is the most important step in the risk management process. Without risk awareness, you cannot manage the risk. But that is just the beginning. Awareness, on its own, possesses an almost passive quality; it does not necessarily include any notion of compelling action to take care of the risk.

“Caring” about risk is where I see the palpable difference between the cultures of the banks and the non-banking entities that I’ve encountered. In the tone and words used by non-banking industry guest speakers in my classes, you can hear that they care deeply about the risks their organizations face. And this caring seems to be embedded in the culture of their organizations — at all levels in the employee hierarchy, in all business and control units.

Here are some of the phrases these organizations have repeated in my classes: “Risk management is a team effort.” “Every employee is part of the risk management process.” “We use culture-building as a risk mitigation tool.” “Every single employee is a member of the risk team.” “We give every employee from the janitor to the highest-level executive the same culture training, including that every employee is part of risk management.” Have you ever heard a bank sincerely state that every employee is part of the risk team? Could you imagine a bank telling all its employees that they were part of the risk management process?

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These organizations — with limited resources dedicated to stand-alone risk management functions, limited risk management documentation, limited risk management governance — they are not only aware of their risks, but they care deeply about managing these risks. Executives on the front line, and those in risk management and audit functions in these organizations, do not view risk management as a compliance or check-the-box exercise. These organizations are not ends-oriented, managing risks to satisfy a Matter Requiring Attention or a Matter Requiring Immediate Attention or some other regulatory guidance. They manage risk because they deeply care about protecting their organizations, their assets, their employees, their customers, and their reputations.

**Q:** The industry standard three lines of defense (“3LoD”) risk management framework has come in for criticism from many quarters,<sup>1</sup> and it appears ill-suited to managing the sort of cultural issues we’re talking about. What’s your view here?

**A:** Consistent with regulatory guidance, many banking organizations have adopted a three lines of defense risk management framework: the first line is the front line, the business units creating risk must own and manage the risk; the second line is the independent risk management function, assessing, monitoring, and reporting on the first line’s risk-taking activities; and the third line is the audit function, validating the effectiveness of the risk management framework.

I have grown more and more skeptical of this framework. And the recent bank failures have solidified that skepticism. I should state at the outset that no risk management framework, no matter how strong, is going to be able to stop a liquidity run. So, a core objective of a risk management framework must be to prevent a liquidity run from ever starting.

One problem I see with the 3LoD framework is “social loafing” — when individuals in a group rely on others in the group to do their work. At times the first line, the business units, may be relying on the second line to identify and manage the risks of those business units rather than the business units managing those risks themselves.

Silicon Valley Bank provides a good example. Much has been made about the fact that Silicon Valley Bank lacked a chief risk officer for most of 2022. Many have pointed to this as the reason for the bank’s inability to manage its risks, namely its interest rate risk and liquidity risk, thus triggering its ultimate failure. However, if we sincerely subscribe to the 3LoD framework, shouldn’t we be pointing to the bank’s treasury or finance function that actually purchased and managed the securities portfolio? Aren’t they supposed to be experts in interest rate risk management and liquidity risk management?

Under the 3LoD framework, the business units own the risk. They should understand risks better than or as well as any risk management or audit function at the bank. Does the three lines of defense framework encourage the first-line risk-takers to not manage their own risks because they think they can offload those risk management responsibilities to the second line? Do the business unit leaders feel they can shirk their risk management responsibilities because some second-line control function with “risk” in its title is overseeing their risk-taking activities?

The *single* explicit mention of the finance and treasury functions’ risk management responsibilities in the Board of Governors of the Federal Reserve System’s [April 2023 Review of the Federal Reserve’s Supervision and Regulation of Silicon Valley Bank](#) may be telling: “While it is the responsibility of the businesses and functions like finance and treasury to manage risk in a safe and sound way in accordance with the board of directors’ risk appetite, the vacancy

in a post like CRO removes one layer of important internal oversight.” Shouldn’t there be more explicit focus on finance and treasury? Again, they own the risk; they are responsible for managing the risks associated with their activities; they are the first line of defense.

One more point to tie this back into a risk-caring culture. A risk-caring culture — a culture where all employees sincerely feel they contribute to the risk management process and wish to do so — is what stands up and operationalizes an effective 3LoD framework and, generally, any effective risk management program. In [its April 2023 Review of the Federal Reserve’s Supervision and Regulation of Silicon Valley Bank](#), the Fed discusses the weakness in its own supervisory culture — a courageous admission on its own — but nowhere does it discuss the weakness in Silicon Valley Bank’s culture when, in fact, that culture is what did the bank in.

Policymakers and regulators may be relying too heavily on incentive compensation design to “cure the crisis in culture.”

**Q:** You were at the US Department of the Treasury during the financial crisis, and worked on corporate governance and executive compensation standards for participants in the Troubled Assets Relief Program (TARP). These standards aimed to use incentive compensation design as a risk management tool, trying to dampen excessive risk taking. What does this experience instruct as to the efficacy of managing risk through comp programs?

**A:** I think policymakers and regulators may be relying too heavily on incentive compensation design to “cure the crisis in culture.” This started over 20 years ago: The most famous example being the Sarbanes Oxley Act clawback provision, which authorized the Securities and Exchange Commission to compel CEOs and CFOs to reimburse the company for their incentive compensation upon a company’s financial restatement due to corporate misconduct.



In the wake of the financial crisis, the use of incentive compensation as a risk management tool became still more pronounced, the thought being the following: we can adjust individual behavior, that is, turn the individual away from “excessive risk-taking” and causing “material adverse effects” on a company, through well-designed incentive compensation.

This design is a somewhat paradoxical push-and-pullback structure: the incentive portion inclines the individual to take risks; and the risk management overlay attempts to harness the individual’s risk-taking by doling out consequences for poor outcomes. This overlay is often based on the idea of having skin in the game: we will hold onto your skin, that is, your incentive compensation, for a period of time and, if there are poor outcomes, we’ll claw your skin off.

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A well-designed incentive compensation plan can reinforce a risk-caring culture, but I doubt it will ever create one.

*This essay originally appeared in Starling’s 2023 Compendium. Please visit [Starling Insights](#) to read the full report.*



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## ENDNOTES

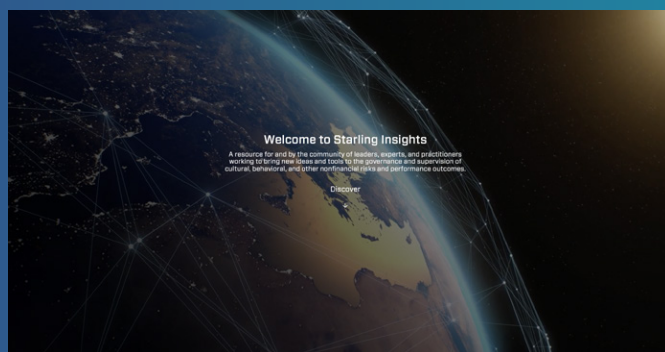
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- 1 Starling Insights, “Rearranging the Deckchairs,” Deeper Dive, May 17, 2021. [LINK](#) ►

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