The paradoxes of risk management in the banking sector

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ABSTRACT

This paper uses empirical evidence to examine the operational dynamics and paradoxical nature of risk management systems in the banking sector. It demonstrates how a core paradox of market versus regulatory demands and an accompanying variety of performance, learning and belonging paradoxes underlie evident tensions in the interaction between front and back office staff in banks. Organisational responses to such paradoxes are found to range from passive to proactive, reflecting differing organisational, departmental and individual risk culture(s), and performance management systems. Nonetheless, a common feature of regulatory initiatives designed to secure a more structurally independent risk management function is that they have failed to rectify a critical imbalance of power - with the back office control functions continuing to be dominated by front office trading and investment functions. Ultimately, viewing the 'core' of risk management systems as a series of connected paradoxes rather than a set of assured, robust practices, requires a fundamental switch in emphasis away from a normative, standards-based approach to risk management to one which gives greater recognition to its behavioural dimensions.

Keywords: Risk management; paradox theory; power imbalance; regulation; behavioural; three lines of defence.
1. Introduction

In commenting on the global financial crisis, academics, regulators, banking supervisors and practitioners all identify shortcomings in corporate governance and risk management as key causes (see, for example, Financial Stability Institute, 2015; Magnan & Markarian, 2011; Power, 2011; OECD, 2009; FSA, 2009; Bernanke, 2008). While the strength - and perceived effectiveness - of risk management practice is suggested as being dependent upon underlying risk cultures (Arena, Arnaboldi, & Azzone, 2010; Mikes, 2009), and while the heterogeneity of risk management systems across organisations continues to be emphasised (Arena et al., 2010; Mikes, 2009; Woods, 2011), detailed academic studies of practice, especially in financial services, remain rare but are still much needed (see Van der Stede, 2011). The importance of gaining a deeper, institutional level knowledge of risk management practice has been heightened by post-crisis calls for practice improvements that cannot easily be addressed in the absence of such detailed knowledge.

Risk management systems in banking are underpinned by regulatory pressure to ensure that risk and compliance functions, supported by internal audit, are independent of revenue generating functions. Organisational independence for risk managers, however, raises questions about how different functions interact, and the extent to which risk management staff are able to exercise influence and control over the risk taking behaviour of corporate bankers. This paper seeks to shed light on some of the interactive/behavioural dimensions of risk management which Power (2009) considers to have been underemphasised. It is also a direct response to Kaplan’s (2011, p. 374) call to address the question of “what is the relationship between professional risk managers and line management”. We explore the interconnections between organisational structures, management controls and incentive systems, and following Rousseau’s (1985) approach, take the view that it cannot be assumed that concepts such as risk are commonly defined and uniformly understood within an organisation.

Using interview data, the paper explores differing staff viewpoints of risk management and internal control practices in the banking sector and the strategic significance and degree of resolution of such differences in practice - issues that, to date, have largely been ignored in the literature. Our analysis of the interaction between the revenue generating and risk and control functions confirms high profile declarations by financial services regulators of an “imbalance between the stature and resources allocated
to firms’ revenue generating businesses and those afforded to the risk and control functions.” (Senior Supervisors’ Group, 2009, p.22). Gendron, Brivot, and Guenin-Paracini (2016) found that board members tend to excuse risk management failings, protecting and preserving the legitimacy and credibility of the risk management ‘core’ whilst over-simplifying underlying practice. We conclude that such protection of risk management systems clouds the fact that their formal structures are less important than the issue of an imbalance of power; consequently, risks may not be as well controlled as such systems might suggest.

Conceptually, the paper extends Gendron et al.’s (2016) analysis and understanding of risk management practices by drawing on the framework of paradox theory (Quinn & Cameron, 1988). While paradox theory has been extensively studied and developed within the organisational studies literature, our approach is novel in applying such a theoretical framing to the study of risk management. Paradox is defined as “contradictory yet inter-related elements that exist simultaneously and persist over time” (Smith & Lewis, 2011, p. 382) and paradox theory explores how organisations respond to, and seek to manage, the tensions which arise when simultaneously pursuing competing objectives (Lewis, 2000; Smith & Lewis, 2011; Jarzabkowski, Le & Van de Ven, 2013). Banks face a paradox of objectives in respect of market versus regulatory demands, as was clearly demonstrated by the global financial crisis – with the Turner Review describing how the search for a “ferocious” yield by investors led to financial innovation and the creation of complex products whose risks were poorly understood (FSA, 2009). Financial returns were seen as having taken precedence over risk management.

Empirically, we draw on thirteen interviews with front and back office risk management staff working in the Singapore offices of ten global financial institutions and two regulatory bodies, to develop insight and understanding of the organizational significance of the competing demands of generating profits while remaining compliant with regulatory risk requirements. Singapore provides a unique setting for risk management research in a global context as it is a major centre for trade in commodity, foreign exchange and interest rate derivatives and in 2013 Singapore handled 40% of all Asian OTC derivatives trades (Davies & Grant, 2013). Such a global standing was helpful as it meant we could work with banks of varying geographical origin (including the US, Europe, Asia, and the Middle East).

Building on the existing literature, we illustrate how a core ‘market-regulatory’ paradox stimulates more operationally specific paradoxes and tensions which affect the
organisation of risk management systems, the measurement of staff performance and staff allegiances to the risk culture. Our categorisation of types of paradoxes matches closely the paradoxes of organising, performing, belonging and learning identified by Lewis (2000) and Luscher and Lewis (2008). We find the core ‘market-regulatory’ paradox to be a common feature across all the financial institutions studied, but observe operational variations in the risk management responses that reflect differences in organisational and departmental risk culture(s), performance incentive systems and personal risk actor profiles. Responses range from being largely passive in nature – “we do what is needed to make the system work” – to proactive searches for ways to resolve the paradoxes, and our observations align with the suggested acceptance versus resolution responses discussed by Smith and Lewis (2011).

Regardless of the responses, however, the fundamental paradox of market versus regulatory demands remains in place, creating persistent challenges for risk managers. We conclude that there are strong analytical grounds for arguing that existing models of risk management are fundamentally flawed. Regulation, and stylised risk management systems have, to date, been largely unsuccessful in restraining/redressing the imbalance of power between ‘revenue generating’ and ‘risk and control’ staff. We suggest that attention should therefore shift towards understanding better the nature and significance of such power differentials (i.e., knowing where the power lies, how it is exercised and with what consequences). The analytical priority has to move away from a reliance on standardised risk management systems to a better understanding of how people accommodate and live with the day-to-day tensions and contradictions of ‘risk managed’ organisations.

The remainder of this paper is organised as follows. The next section reviews the literature on risk management in financial institutions, while section 3 outlines our theoretical framework. Section 4 details the research context and method, and section 5 presents our empirical findings. Discussion of our key findings and a conclusion complete the paper.

2. Literature Review

As already noted, in responding to the global financial crisis, politicians (G20, 2008; OECD, 2009), regulators (Senior Supervisors Group, 2009; Committee of European Banking Supervisors, 2010; Basel, 2010) and practitioners (KPMG, 2011; PwC, 2012)

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1 These concepts are explained in the theoretical framework section of the paper.
have all questioned risk management practice within the banking sector and continue to argue the case for change.

Criticism of risk management has also extended to the academic literature. Power (2011) highlighted the illusion of control that can result from extensive formalised guidance and standards which encourage a focus on regulatory compliance. The emphasis on quantification, standardization and legitimation (De Bondt, 2010) can also be criticised for encouraging a ‘risk management by numbers’ mentality (Mikes, 2009) and there have been strong increasing calls for a broader-based understanding of the relationship/behavioural dimensions of risk management (De Bondt, 2010). The interconnectedness and complexity of both risk exposures and control systems in organisations, or what Vit (2013) refers to as the ‘non-economic logics’ that are required to govern and manage risk, however, have often been neglected by researchers. This is perhaps surprising given that Kloman (1990), writing about risk management a quarter of a century ago, recognised the need to understand the complex interrelationships that exist in everything we do. The significance of appreciating the behavioural dimensions of risk management was highlighted by Power (2009), who stressed that failure to consider interactions within and between organisational actors can lead to the risk management of nothing.

Regulators have similarly acknowledged the need for a better understanding of how risk management staff interact with business line managers and the potential governance implications of such interactions. A Senior Supervisors Group report (2009, p.38) concluded that “increased co-ordination and interaction between the risk management function and the business lines needs to be …ingrained into the corporate culture if the benefits are to be sustainable and effective.” These comments echoed those of the Institute of International Finance (2008) which declared that “…development of a ‘risk culture’ throughout the firm is perhaps the most fundamental tool for effective risk management” (IIF, 2008).

Research into the behavioural dimensions of risk management needs to take into account the historical context within which risk management systems in the banking sector have developed, at both the international (e.g., through Basel Regulations) and national level (e.g., as specified by local supervisory authorities) – and the impact that such regulations have had on the design of internal risk management systems.

The original international rules, framed under the Basel I Accord (Basel, 1988) focused on defining bank capital and establishing risk-based rules for capital adequacy.
Growing complexity within financial services, combined with a series of financial scandals in the mid 1990’s, such as Daiwa Bank (1995), Barings (1995), and Sumitomo (1995), however, shifted the focus from capital adequacy to supervisory oversight and review of internal control systems. Concerned finance ministers of the G7 group of countries called for more effective supervision of bank risk taking and in response the Basel Committee published guidelines for internal control in banking organisations (BIS, 1998). A key element of the guidelines was Principle 6 - a requirement for banks to segregate the duties of those involved in profit generation (front office) from those responsible for control and compliance (back office). This was complemented by Principle 11 of the guidelines which defined the role of internal audit as reviewing the internal control system and reporting to senior management and/or Board of Directors on the outcome of that review. Independence of the control function and internal audit was thus a central tenet of the guidelines, and resulted in three distinct functional groups within banks – the front office, risk and control, and internal audit.

These groupings have come to form the basis of the ‘three lines of defence’ (TLOD) model of risk management, which identifies three categories of staff as holding responsibility for risk management. The first ‘line of defence’ is the front office staff. The central risk management function, which establishes the rules and systems to control risk taking, is the second ‘line of defence’. The third ‘line of defence’ is internal audit, which is responsible for testing control effectiveness and advising senior executives accordingly.

The TLOD model prescribes a distinct role for independent risk and internal audit functions, and thus provides a structural framework for compliance with the Basel Committee guidelines on internal control. Its general historical origins, possibly deriving from sport or the military remain unclear (Davies, 2013), but its adoption by banks appears to have been driven by its capacity to represent a way of operationalising, and legitimising, the regulatory requirement to split the front and back office functions. In this regard, the TLOD model was recommended to banks as a useful template by the UK’s Financial Services Authority (FSA) in 2003 (Davies, 2013). Some years later, a UK consultation paper (FSA, 2010) on improving operational risk management in financial institutions referenced the widespread use of the model and its particular merits when supported by a strong risk culture.

At an international level, use of the TLOD approach has been endorsed in publications of the Basel Committee on Banking Regulation (Basel, 2011; Basel, 2012). Additional, unequivocal support for TLOD came from the USA in 2014 when the Office
of the Comptroller of the Currency (OCC) issued formal guidelines for a bank’s governance framework requiring the establishment of the three component elements (lines of defence): front office, independent risk management and internal audit (OCC, 2014). Post crisis, therefore, regulatory support for the TLOD not only persists, but its role in risk management is now firmly established, with its use in the banking sector being described as “ubiquitous” (Davies, 2013).

In a wider context the TLOD model was endorsed by the European Confederation of Institutes for Internal Auditing in 2012 (ECIIA, 2012), which described it as essential for establishing clearly-structured corporate governance systems. Less than a year later the Institute of Internal Auditors issued a position paper that argued that the TLOD model “can enhance clarity regarding risks and controls and help improve the effectiveness of risk management systems” (IIA, 2013, p.3). Since then, the IIA has strongly promoted the model on the global stage, with its use being extended beyond financial services and into all types of business (see, for example, COSO, 2015).

Nonetheless, the TLOD model has been criticised for its failure to reflect the organisational challenges of risk management practice (Power, Ashby, and Palermo, 2014). At its simplest, this is illustrated by the fact that the TLOD model does not recognise the potential additional lines of defence that may be enacted by the Board of Directors, external auditors and regulators (Power et al., 2014; FSI, 2015). Other fundamental organisational issues which illustrate its weaknesses include problems of conflict between risk responsibility and profit generation in the first line of defence, a lack of organisational independence, knowledge and expertise in the second line of defence/control function, and inadequate risk oversight by internal audit - the third line of defence (for more discussion, see FSI, 2015). Such criticisms suggest a need to look beyond the mere structure of TLOD - and to focus more on the interactions between each of the three lines of defence, if we are to gain a better understanding of risk management practice.

The relationship between staff in and across the different lines of defence, including the relative power exercised by front and back office staff can be viewed as institutionally specific, reflecting particular business histories and associated influences on codes of management behaviour, morality and the local understanding of risks (Arena et al., 2010). Ashby, Sharma and McDonnell’s (2003) study of financial institutions identified a potential for conflict arising out of a lack of communication between the respective parties, while Mikes (2009) similarly suggested that using risk management for
organisational control can meet with resistance. More specifically, Power et al. (2014) found examples of tensions between the first and second lines of defence, suggesting that whilst a certain degree of conflict is healthy as it implies a “challenging” risk function, there is a delicate balance to be sought. Excessive challenge can be alienating to business line staff, but excessive friendliness by the risk management staff may imply weak controls and staff who “can become captured and end up in bed with the business” (Power et al., 2014: 28). One possible explanation for such tensions might lie in different attitudes to risk across front and back office staff. Wahlstrom (2009), for instance, found core differences in the frames of reference used by the two groups to interpret risks that also influenced their respective attitudes to the usefulness of external Basel II banking regulations.

Problems arising from different attitudes to risk may be further compounded by issues surrounding the relative status of risk management staff vis-à-vis traders or corporate bankers. In research predating the global financial crisis, Willman, Creevy, Nicholson, and Soane (2002) found that traders’ strong sense of autonomy affected the way in which risk taking was managed, with increased autonomy creating increased challenges for the control function. The £3.7 billion of trading losses incurred by Société Générale in 2008 were blamed on a control function that lacked the power to exercise “critical scrutiny” (Société Générale, 2008) and thus facilitated the fraud. In a similar vein, a report by the SEC into failures at Bear Stearns, concluded that the proximity of risk managers to traders was indicative of a lack of independence (SEC 2008).

A study by Stein (2002) suggested that the organisational structure of the risk management function influenced the extent to which risk information was shared between management and the business lines. Ellul and Yerramilli (2013) tested this idea further in a large scale analysis of the significance of risk management in US-based bank holding companies (BHC’s) over the period 1995-2010. Using an index to measure the strength and independence of the risk management function, the authors tested the hypothesis that institutions with a strong and independent risk function should, ceteris paribus, have lower tail risk. They concluded that BHC’s with stronger pre-crisis risk management functions had lower tail risks during crisis years, but there was no association between risk management independence and tail risk in non-crisis years. Research by Keys, Mukherjee, Seru, and Vig (2009) also found that risk taking was linked to the status of the risk management function. Using the senior risk manager’s share of the total compensation paid to the five most senior bank executives as a proxy for their power,
Keys et al. (2009) showed that the default rates on mortgage loans were lower in those banks where the risk manager’s power was higher.

In summary, research evidence to date suggests that in complying with regulation by implementing the TLOD model, banks face challenges surrounding the way in which risks are respectively understood by line and risk management staff, how those risks are communicated across the TLOD, and the degree of power and influence granted to, and exercised by, the risk management function. Whilst the TLOD model is widely used by financial institutions, we still know relatively little about how it is operationalized in practice and how conflicts, tensions and basic communication between the different levels of defence are managed. Paradox theory was developed as a way of describing and explaining how entities deal with competing demands and objectives (Smith & Lewis, 2011) and it is used in this study to discuss the relationship between risk and line management staff in banks, providing detailed examples of conflicts between the two groups, and analysing how organisations and their staff respond to such conflicts. The next section of this paper outlines this theoretical framework in more depth.

3. Theoretical Framework

3.1. Types of paradox

The literature on paradox theory suggests the existence of four different types of paradox: namely, the paradoxes of organizing, performing, belonging and learning (Jarzabkowski et al., 2013; Lewis, 2000) that may be found at different levels within an organisation. The organizing paradox is concerned with processes at the entity level, whereas the paradoxes of performing and belonging relate to specific tensions faced by individuals at all levels across the entity. The paradox of performing concerns the goals that individuals are required to meet, and the paradox of belonging refers to tensions between an individual employee’s loyalties and values and the groups and group values with which he/she may be required to conform (Smith & Lewis, 2011).

At the entity level, the organizing paradox is observed when an entity seeks to create overall systems to manage conflicting goals and tensions between different parts of the same organisation (Lewis, 2000). The aim is to create a coherent and integrated whole which is structured in a way that ensures overall organisational goals are achieved. Jarzabkowski et al. (2013) illustrate the organizing paradox through a case study of a telecommunications company faced with two distinct units that have conflicting
objectives. One division is market focused, centred on meeting the requirements for high quality, competitive services; another division does not have direct market contact, and is constrained by the need to comply with various regulatory demands. Many organisations are subject to extensive regulation, or public oversight. For example, those involved in environmentally sensitive activities such as oil exploration must attempt to balance the conflicting interests of the environmentalists with those of their shareholders, for whom profit is the presumed primary objective. Addressing and respecting such concerns whilst, at the same time, generating satisfactory investment returns for shareholders represents an organising paradox.

The literature also suggests that within an entity individual managers may face paradoxes in their work as they try to deal with contradictory performance demands and expectations from internal and external stakeholders (Donaldson & Preston, 1995). The performing paradox, for example, reflects the contradictions of being required to be both productive and creative, efficient and effective, or to delegate but also to control. Luscher and Lewis (2008) give an example of the Lego Company in which managers are confronted with the challenges of being in charge and yet having to delegate decisions to others. In the context of risk management, performing paradoxes may arise, or be aggravated by performance management and incentive systems which encourage potentially contradictory behaviour. For example, if a back office accountant is evaluated on the basis of the speed at which a front office trade is recorded, then this search for speed may reduce their capacity to evaluate the trading risk, or complete the necessary regulatory compliance paperwork.

A paradox of belonging arises when individuals face a conflict between their personal and social identities in the workplace (Kreiner, Hollensbe & Sheep, 2006). This problem is made more acute when a person simultaneously belongs to several teams, each with conflicting demands. An illustrative example here is the observed lack of trust and resulting anxieties of managers working in both the management team and the production team (Luscher & Lewis, 2008). Such anxieties were seen to reflect the managers ‘personal’ efforts to balance the different social identities (needs and values) of each different team as well as their own personal identity. In earlier work, Pratt and Foreman (2000) suggested that individuals compartmentalise each of their different social and individual identities, although Luscher and Lewis’ (2008) observation implies that such compartmentalisation may not work in cross-functional team settings where staff may be members of more than one functional team.
The paradox of belonging may be useful in gaining a better understanding of risk management failures. At the macro level, for example, a bank may face a paradox of belonging between its own internal risk culture and that of regulators. At a micro level, the individual risk manager may see a mismatch between their own, personal risk preferences and the team or group’s risk culture. Any such paradoxes may mean that risks are not being managed in a uniform way across the bank, and may give rise to conflict between individuals/groups with differing risk preferences. Such conflicts could undermine the effectiveness of the risk management system.

The paradox of learning comes from contradictions between building on existing knowledge and creating new knowledge (Lewis, 2000; Smith & Lewis, 2011). Examples from the literature include tensions between radical and incremental learning (Smith & Lewis, 2011) and exploitation and exploration (Andriopoulos & Lewis, 2009) in relation to product development. Creative disruption is another example of the learning paradox, in which organizations capitalize on and yet cannibalize their existing product(s) (Christensen, 1997). Smith and Lewis (2011) argue that learning paradoxes emerge as systems change and innovate, and this is useful for considering how managers deal with the tension between retaining old familiar ways of managing risk versus the adoption of new and possibly controversial approaches. The paradox of learning is especially relevant to risk management as techniques and practices evolve in response to new regulations and as new financial products are created to meet changing market demands.

All four forms of paradox may coexist, interact and cascade down through an organisation - from the organisational level, through to functional and individual levels (Smith & Lewis, 2011; Jarzabkowski et al., 2013). Lusher and Lewis (2008) found the performing paradox to be intertwined with organising and belonging paradoxes, especially when managers belong to different teams and face multiple reporting lines and performance targets. In the risk management context, multiple reporting lines may serve to blur the lines of accountability, thus undermining the effectiveness of risk controls.

Jarzabkowski et al. (2013) suggest that as the paradoxes co-evolve, managers may change their responses, shifting from a defensive standpoint that provides only “short-term relief” (Jarzabkowski et al., 2013) from prevailing paradoxes, in favour of more active responses to try and manage the paradox(es) over the longer term. Such shifts are said to be key to organisational survival (Jarzabkowski et al., 2013), making the distinction between defensive and active responses highly significant.
3.2. Responding to paradoxes

Paradoxes may remain latent, and even be unrecognised in an organisation, but if they become salient, and affect the behaviour of organisational actors, then an organisational response is generated (Smith & Lewis, 2011). Alternative defensive responses include splitting, suppressing, and projection.

Splitting involves separating the contradictory elements into different parts of the organisation, for example by setting up different divisions. Suppressing involves placing priority on one element and allowing it to dominate over others, whilst a projection response passes the blame for failure to achieve conflicting goals onto a third party, such as an external regulator. None of these responses, however, eliminate the underlying paradox. Indeed, it has been argued that such tensions are often not confronted directly (Smith & Lewis, 2011), and managers simply accept and ‘live with’ a paradox. In the literature, accepting and adjusting behaviour is categorised as an active response only if the managers explicitly recognize the contradictions (Jarzabkowski et al., 2013) and try to manage them long term. Accepting involves identifying ways of balancing the differing perspectives, but adjusting actively engages the competing parties in finding a solution to the tensions. A third, and more sophisticated, response is that of transcendence in which the competing viewpoints that create the paradox are reinterpreted as interdependent elements rather than a paradox (Jarzabkowski et al., 2013).

Using the above delineated framework of paradox theory, the empirical evidence presented in section 5 examines the different paradoxes in risk management systems and the differing ways in which such paradoxes are handled/managed. Particular attention is given to the interaction of, and tensions between, market and regulatory priorities for the operation and overall functional efficacy of risk management. The market versus regulatory paradox occurs at the organisational level, and cascades down to create tensions for individual staff within the banks in terms of their risk management role. Before presenting the research evidence, however, we outline below our research method and site selection.

4. Research Methods

4.1. Research context and data sources

Our chosen research site was Singapore which, according to the Bank for International Settlements was ranked in 2013 as the largest foreign exchange trading
centre in the Asia Pacific region and the third largest globally. Singapore is also ranked as
the largest OTC interest rate derivatives centre in Asia Pacific (excluding Japan). The
scale of market opportunities offered by Singapore has attracted a wide range of
international banks to the city and it is the risk management staff in these institutions, and
the associated regulatory authorities, who are the focus of this research. The international
banks in our study are subject to local regulation by the Central Bank (Monetary
Authority of Singapore) and the Singapore Stock Exchange, in addition to international
regulations under the Basel Capital Accord.

Table 1 details the geographic diversity of the institutions included in our study
and the functional roles of interviewees who included regulators, business development,
credit risk, compliance, product control, operations risk and internal audit staff.

## INSERT TABLE 1 HERE

Interviewees’ experience levels ranged from six months to twenty years. All
interviews were conducted between August 2013 and May 2014. Of the fifteen
interviewees approached, thirteen responded positively. The high response rate perhaps
reflects the benefits of researching in a co-operative Asian culture, but also of using
personal contacts to initiate an introduction. We acknowledge the limitations of this
method of selection, and the potential bias that it might imply, but we believe this risk has
been mitigated by the fact that our study embraces a total of nine different organisations -
seven financial institutions with geographical origins ranging across Europe, Asia, the US
and the Middle East, and two regulatory bodies (See Table 1).

Clarification of the respective job titles that sit within the three lines of defence is
helpful in understanding the nature of the work done by the interviewees. The first lines
of defence, or front office, includes asset managers, corporate bankers and traders, all of
whom seek to generate profits by taking risks on behalf of the organisation and its clients.

The back office (second line of defence) is comprised of the credit risk
management, compliance, product/business controller and operational risk departments.
The credit risk manager evaluates the credit risks of potential borrowers and
approves/rejects loan applications. The compliance officer ensures organisational
compliance with the laws and regulations of the jurisdiction(s) in which it operates. The
product/business controller is responsible for the accounting and financial reports of the
businesses, ensuring that the financials are consistent with the accounting standards. The operational risk officer assesses the business processes to minimize the risks of loss from system inadequacies or failures. The third line of defence, the internal audit function, typically has a direct reporting line to the senior management of the organisation and is responsible for audits of both front and back offices.

A hybrid role, not explicitly recognised with the TLOD model, is the function commonly termed business development. The individual in charge of business development is responsible for the returns earned for the business by the front office, but also the day-to-day management by back office staff of the associated risks, including regulatory compliance. As such, the business development manager straddles the first and second lines of defence and the risk management paradox as they seek to “balance contradictory yet interrelated elements that exist simultaneously and persist over time” (Smith & Lewis, 2011, p. 382).

4.2. Interview protocol

Each interview lasted 1-2 hours and two interviewers were present at each one to facilitate the researcher-participant exchange and to validate the extensive notes taken on interviewee responses (serving as a valuable supplement to the verbatim transcriptions of the audio content). We believe that the length of interviews helps to mitigate the relatively small number undertaken. The interviews were semi-structured, incorporating open-ended questions about issues such as: the relationship between staff in the first and second lines of defence; official organisational mechanisms or responses that existed (if any) to help resolve paradoxes and associated tensions; the relative power held by front and back office staff; and the organisational risk culture and performance incentive structures. Interviewees were also asked to provide specific examples/anecdotes to illustrate how risks were managed in practice. Whilst we allowed interviewees the opportunity to express and develop a range of views, prompted by appropriate follow-up questions, we nonetheless ensured that the main issues and research themes were satisfactorily covered.

All interview notes were written up within twenty four hours. A third researcher (not involved in the interview process) subsequently reviewed the interview notes and acted as an independent commentator on the main themes and issues that were identified.

4.3 Data analysis
To preserve confidentiality, each of the thirteen interviewees was assigned a code number for data collation purposes and information on the relevant codes was retained in a secure file. Analysis of the interview data took the form of a series of iterative stages, using an interpretative line of enquiry similar to that described in Gendron et al. (2016). In the first stage of our analysis we sought to identify and classify the interviewees’ responses into the types of paradox identified and discussed by previous researchers, namely organizing, belonging, performing and learning. In mapping the individual and organisational responses to paradoxes against the categories suggested in the theoretical framework, we also sought to distinguish whether responses were defensive or active in style (Jarzabkowski et al., 2013; Smith & Lewis, 2011). The example below illustrates how the themes were linked back to the literature.

Example

“The Accounting Policy team works closely with the legal team, and they will look at various criteria in the terms of the loan to see how much revenue can be recognised. It depends on the terms, whether there is risk-sharing. We may take it off-balance sheet, or recognize in the balance sheet. We recognise the asset and liability of the loan, so if we de-recognise, we take both the asset and liability out. Actually there has been an attempt in (the bank) to make the balance sheet as lean as possible because it affects the risk rating. So a lot has been taken off-balance sheet.”

Interviewee 12: Product Controller, European Bank

As a product controller, interviewee 12 is responsible for the accounting records for the trading transactions and activities of the corporate bankers. Accounting for derivatives and other financial assets is highly complex, and the subject of a much revised and very lengthy international accounting standard (IAS39, now IFRS 9). The above quote relates to the accounting regulations on revenue recognition and highlights the fact that the structuring of a loan (as determined by the corporate banker) has implications for the accounting for the transaction, and the institution’s balance sheet, which is also subject to risk related regulation. Under the Basel regulations, the amount of capital that a bank must hold is directly linked to the risk levels of the assets held on its balance sheet, and so a “lean” balance sheet with fewer risky assets is more attractive as it reduces capital requirements. The example clearly
illustrates a paradox between arranging loans that might generate ‘good’ returns for the bank - but at possibly high risk - and structuring loans that, whilst offering lower returns, can be taken off-balance sheet. We interpreted this as an example of the paradox of performing, which is defined by Smith and Lewis (2011) as stemming from a plurality of stakeholders and resulting in a number of competing strategies and goals. In the above example, the product controller responded to the paradox by working to lower the institutional risk profile and capital requirement by taking assets and liabilities off the balance sheet. We classified this as an active response which also demonstrated the recurrence of the same paradox across different levels: organisation, unit (risk management) and individual (product controller). The next section reports our findings, categorised in accordance with the range of observed paradoxes.

Our second stage of analysis involved reflecting on the organisational significance of the paradoxes we identified and the way in which they are responded to and managed. A key consideration here was the scope to consider the validity of the assumptions underpinning the TLOD model and its contribution to securing ‘effective’ risk management.

5. Empirical Findings

5.1. Risk Management and the Organising Paradox

External factors have the capacity to significantly influence a bank’s business strategy. Regulators control bank risk taking via rules on risk and capital measurement, inspection and supervisory oversight of internal control systems, and accounting and reporting standards. Simultaneously, the financial markets impose pressures on the banks to generate ‘acceptable’ investment returns whilst also demonstrating ‘reputable’ behaviour. Banks, therefore, face a paradox of organising in respect of how to best structure themselves in a way that accommodates and manages the challenge of its market versus risk based regulatory demands.

The paradox of organising was clearly expressed by a senior interviewee working in a European bank when discussing the measurement and control of risk:

“Banks are in this for profit-making. What incentive is there to put controls into their processes? Financial risk (compensation to clients when things blow up) is pretty intangible. Even if they see some financial risk, there is a lot of opposition to respond to this. Front office bankers will object and say it (controls, measures) impedes sales
and upsets clients. Management (of the bank) wonders what the purpose of doing it (controls, measures) is for.”

Interviewee 7 (Compliance Officer)

The highlighted scope for conflict between front and back office reflects paradoxical objectives. Jarzabkowski et al. (2013) used the term ‘splitting’ to characterise how a telecommunications company responded to a similar organising (market-regulatory) paradox by dividing the company into two separate units (one customer-facing, the other regulatory-facing). As already noted, in banks, the split between the market-facing front office and the regulatory-facing back office was an outcome of the regulatory requirement for segregation of duties under Principle 6 of the Basel Framework for Internal Control: (Basel, 1998). The TLOD model which grew in popularity just a few years after the Basel framework was published, provided a stylised response to the splitting of front and back offices, as it identified a way to get the front office to take responsibility for risk. The TLOD facilitated the creation of a rationalising structure of risk management, even though its effectiveness may be open to question.

The impact of this response to the organisation paradox is illustrated in the following quote:

“In the old days, corporate bankers looked for a customer, sourced the deal, assessed the credit risk of the customer/deal, and took on the risk of bad debt. Thus, they were careful to take on (only) good risks. The origination perspective of loans is that it needs to measure the downside of loans for the corporate bankers. In the current construct, that link is lost. The credit risk officer role is separated from the corporate banker role. The credit risk officer is the one to reject loan applications with his/her performance tied to his/her credit assessment. The front office is assessed solely on revenues with little accountability for bad debts.”

Interviewee 6 (Internal Auditor)

The sentence in italics implies that splitting means corporate bankers may no longer be concerned about the risk of the loans they generate, particularly if their performance is revenue-focused. Despite being forced by regulation to split the functions, our evidence suggests that banks have simply created a new paradox/tension around the interaction between the front and back offices.
“This is the nature of the business. If front office agrees with Compliance, then front office has probably lost its edge and is too conservative. But if Compliance agrees with front office, then Compliance has conceded ground. A balance is needed.”

Interviewee 7 (Compliance Officer)

The problem in practice is how to achieve such a desired balance, and this raises issues of compensation, performance management, and organisational structure and culture. The TLOD model is reflected in the organisational structure within banks and assumes that staff in the first line of defence (front office) accept a degree of responsibility for managing risks. Splitting does not, however, automatically grant power to the back office over the front office, and if incentives are misaligned then risk controllers may be unable to restrain the bankers’ risk taking. The so-called ‘tone at the top’ of the bank can offer guidance on attitudes to risk but such ‘official’ declarations are not always well understood:

“A European bank started the mantra: “it is not the results per se, but how you achieve results”. This seems to place more emphasis on values, as a means to control the trading environment. However, it is not known how management values are being measured.”

Interviewee 5 (Product Controller)

Staff face a challenge regarding how to interpret management values, and regulators have sought to help by formulating commentaries and guidelines on risk culture:

“An Asian Central bank has defined four main areas of risk culture framework from the audit perspective including infrastructure (tools and techniques), tone from the top, people/communications. The bank has adopted risk culture measures such as management control awareness, ratings, repeat control issues, control self-assessment, response time to issues, MIS (Management Information System) reporting, and measures of information flows to management. Still, ultimately risk culture is subjective and difficult to measure. The key question to determine a firm’s risk culture is: at trade origination date, is the banker willing to walk away from the deal if it does not smell right, does not feel right?”

Interviewee 6 (Internal Auditor)
The willingness of a banker to walk away from a deal depends upon his/her acceptance that responsibility for risk remains part of their role. The splitting of functions, however, makes it easier for bankers to pass the risk responsibility back to the second line of defence, even though the TLOD model makes their personal responsibility clear. This potential to ‘pass the buck’ creates tensions across the functional divide. One senior manager in a European bank commented:

“There is tension everywhere! But what is most documented is the front vs. back office tension.”

Interviewee 13 (Compliance Officer)

This viewpoint was reiterated by manager in a US bank:

“The front office sales people are driven by sales revenue targets, while the back office compliance people need to make sure checklists are complied with and product control functions are focused on meeting audit requirements.”

Interviewee 8 (Credit Risk Manager)

In light of the existing literature (e.g., see Wahlstrom, 2009) it might be expected that those working in the front and back offices may also differ in their respective attitudes to risk. This was confirmed by an interviewee from corporate banking:

“Sales and trading floor people have certain personalities. This is done through recruitment – only certain types get recruited for these jobs. Very different from back office people, like product controllers, who normally have audit backgrounds and are more conservative…. back office people are just making sure we go through the right hoops, because front office always tries to think of ways of avoiding these hoops.”

Interviewee 9 (Corporate Banker)

The splitting response encourages recruitment patterns which reinforce the functional divide, further increasing the potential for cross-functional tension. Since 2012 Singaporean regulators have sought to control aggressive selling by requiring all bankers and traders to be registered, with records being kept of those with ‘question marks’ over their performance. It was observed that:
“This should be a deterrent, since hiring banks will check prospective employees against this record, and so it can affect a banker’s future job. But this is only effective for some bankers; the ‘powerful’ bankers are not affected by this. …The ‘powerful’ bankers say – so what? I have a ‘black’ mark, but it’s due to some misunderstanding (they try to explain it away) and, hey, I have this list of valuable clients that I bring with me. So these bankers are very powerful. Management doesn’t want to antagonize them, because if they leave the bank can lose as much as 10% of its business from just one banker. Then management will look back at the regulations and say – ok, the regulations don’t specifically say x, y, z. So compliance has to work hard to convince management that the principles-based rules are actually not that flexible, and we have to remind management of the serious consequences of breaching these regulations.”

Interviewee 13 (Compliance Officer)

We classify this regulatory response - namely, tightening the rules following the global financial crisis - as an adaptation response to the organisation paradox. The crisis highlighted the disconnect between remuneration systems and corporate risk appetite (Kirkpatrick, 2009), so the regulations were adapted accordingly. Further regulations imposing Continuing Professional Education (CPE) requirements on bankers also appear to have had limited impact:

“The regulators have now also put in place CPE hours for bankers, so these consulting firms also provide training to train the bankers and get their required 15 hours of CPE per year. But in reality, they are signing up for all kinds of ‘soft’ courses, like how to communicate with your client, etc. just to comply with the 15 hours of CPE. This is pure form over substance.”

Interviewee 13 (Compliance Officer)

This suggests that the new rules, by providing public evidence of regulatory efforts to control the bankers and reduce risk taking, are helping to legitimise the position of the regulators even though their practical impact on risk management practice within institutions remains open to question. In other words, the adaptation response is short term and, as suggested in the literature, fails to eliminate the underlying paradox.

5.2. Performance Paradox
Banks frequently respond to new regulations by revising their internal policies to adapt to a specific paradox, with one particular example of such adaptation being mentioned by a significant proportion of our interviewees. The Basel capital regulations require banks to hold levels of capital that reflect the underlying risks of their business, but this directly impacts on bank profitability. Higher risk-taking activities, such as trading, require higher capital reserves but, with capital being expensive, banks respond accordingly:

“Actually there has been an attempt in (the bank) to make the balance sheet as lean as possible because it affects the risk rating. So a lot has been taken off-balance sheet.”

Interviewee 12 (Product Controller)

Other interviewees suggested that the capital expense of high risk assets had also changed the products targeted for selling.

“We are looking at how much revenue is brought in (that does not affect the balance sheet). We want a lot of cross-selling, and prefer products that have very little balance sheet impact. Or if there is the same balance sheet impact, we want much higher quality names.”

Interviewee 9 (Corporate Banker)

“The Basel capital rules and macro regulatory environment put a curb on trader risk-taking and made them more risk-averse … in some banks, the support for Compliance is getting stronger. Structured products remain popular and are now viewed as plain vanilla by bankers, largely because of the need to free up capital arising from tougher Basel capital rules. The capital rules incentivize the bankers to do less capital intensive loan products, and more fee-based products such as structured products.”

Interviewee 1 (Regulator)

The Turner Review in the UK concluded that inappropriate incentives may have encouraged the risk-taking that led to the financial crisis (FSA, 2009). Any shift in favour of lower risk products might, therefore, suggest that the regulators have achieved their aims, although Kashyap, Rajan and Stein (2008) found that problems of skewed incentive systems cannot be resolved at the regulatory level, but are instead dependent on the nature of governance at the bank level. Our evidence supports this latter, more complex picture, suggesting that banker behaviour remains driven by organisational incentives and
remuneration systems. In particular, we found examples where the bank compensation structure continues to look only at returns, providing the front office with an asymmetric payoff. The front office receives bonuses if a risky trade pays off but suffers no loss if it turns bad:

“Banker compensation is like an option, except that the front office is paid a ‘premium’ in the form of a salary…. The front office is assessed solely on revenues with little accountability for bad debts.”

Interviewee 6 (Internal Auditor)

It was also suggested that the desirability (to corporate bankers) of high risk loans has been exacerbated by IFRS 9, which allows the full recognition of profits on day one instead of over the tenure of the loan:

“Profitability measurement drives behaviour. Loans are marked-to-market, and the credit spreads are recognized as profits at inception, instead of being amortized over the lives of the loans. The accounting methodology for loans creates pressures on front office to generate incremental revenues and justify the risk-adjusted assets. This induces the generation of more loans to increase marked-to-market revenues.”

Interviewee 6 (Internal Auditor)

The persistence of this type of remuneration system suggests that the splitting response to the regulatory demand for an independent control function has simply resulted in credit risk being a limited consideration for the front office, because performance is measured on returns after adjusting for capital charges. Staff in the first line of defence are, therefore, not taking on the risk responsibilities that are assumed within the TLOD model to be a key part of their role.

In some banks, remuneration systems were said to be more holistic, linking a banker’s remuneration to his/her compliance record, but with limited effectiveness:

“Some banks have adopted the Balanced Scorecard approach, so that that being ‘good’ and not having any brushes with Compliance/regulators affects up to (say) 20% of the banker’s bonus. But some banks don’t really put much weight. Even when the good behaviour counts for 20% of the bonus, the docking of the bonus doesn’t have that much effect, because the overriding thing is to meet the target. The bankers say – okay, I have a black mark and my bonus has been docked by $x, but I met my
target, so I am paid an extra $y which makes the $x docked in my bonus ok. Overall, I am better off by not keeping my slate clean, so long as I hit my target.”

Interviewee 13 (Compliance Officer)

This quote suggests that the system only works when the affected party has what the Americans would call “skin in the game”. With little to lose, the incentive to comply is minimised and the payoff for the individual banker remains asymmetric.

“The bankers’ view is – if it doesn’t affect me personally; who cares? It happens to other people. The bankers are more concerned about day-to-day pressure. Their sense of business (making money) is paramount and they have no sense of ownership and of being responsible. But this is the way they have been trained and rewarded.”

Interviewee 13 (Compliance Officer)

Similar evidence that incentives drive behaviour more powerfully than the disincentives created by regulation is to be found in the many comments we received on the development of what were termed “grey market practices”.

“We have different incentives. Front office people look at bonuses – which are based on deals. Back office people are just making sure we go through the right hoops, because front office always tries to think of ways of avoiding these hoops.”

Interviewee 9 (Corporate Banker)

Grey market practices, or ways of avoiding the hoops, while not illegal, are certainly questionable. Traders were careful to conform to policies relating to issues under the regulatory spotlight such as rate-fixing and the selling of sub-prime products. Nonetheless, there were reported instances of grey practices in the dealing room which fell under the radar of regulators. For example:

“Some traders are operating at the fringes of regulations in the trading of foreign currency options near expiry.”

Interviewee 6 (Internal Auditor)

It would seem that as long as the returns for the client are good, then it is worth the bank pursuing the extra revenue and allowing traders to do so. A comparable example, in a different context, was cited as follows:
“The credit risk system can be overridden to suit a desired credit score according to business requirements. A credit risk report contains quantitative and qualitative factors. The quantitative component had fixed risk weights based on firm size, public versus private, and industry. Scores could be improved by adjusting the qualitative factors. At one stage, the qualitative factors were ignored due to a change in the model to beat the Basel rules. This resulted in an improvement of the score. However, the improved scores did not appear appropriate and had to be over-written. The overwrite resulted in exceptions being raised to management. Excessive exceptions to management would invite queries, thus the model was reverted to retain the original qualitative factors.”

Interviewee 2 (Credit Risk Manager)

The existence of such gaming, combined with the anticipation and pre-empting of regulatory changes reflects the fact that traders are incentivised to invent new products/trades that avoid the regulations. The grey practices are subtle and do not represent explicit deviances from company policies (Westphal & Zajac, 2001) but the comment below suggests that they are relatively common:

“There is a constant tussle between regulators and traders (regarding) moves to increase versus decrease product transparency. Regulators try to impose exchange-traded conditions on OTC products. However, the level of complexity is a function of people’s ingenuity. Traders always come up with even more complex products to avoid the regulations.”

Interviewee 3 (Regulator)

The evidence presented above suggests that institutional forces can drive the practices that employees adopt (termed ‘organizational imprinting’ by Lander, Koene, & Linssen, 2013) and in so doing they may exacerbate the divide between front and back office staff. Two comments illustrate the impact of regulatory pressure on organisational mind-sets:

“Very controls-focused, and much less business-focused. They went through a SOX audit 1.5 years ago, and some points were brought up in the SOX audit for Product Control, so they are now very careful about ticking off these controls boxes….A lot of time is spent checking for compliance, and ticking off checklists, but there isn’t enough analysing of the state of affairs.”
Interviewee 12 (Product Controller)

“Breaches are severely dealt with because my firm has a zero tolerance attitude to infractions. My firm is concerned that if the regulators single it out for fines or censure, its clients may terminate its services because it has been ‘caught out’.”

Interviewee 11 (Business Development Manager)

The requirement for back office staff to control and ensure compliance in the midst of an environment in which front office staff are not inclined to cooperate leaves the control function, or second and third lines of defence, facing a major challenge. In their study of risk culture in financial organisations, Power et al. (2014) posed the question “is the risk manager a policeman, friend or critic of front office staff”? This is a fundamental issue.

Luscher and Lewis (2008) cite the example of managers who are required to be in charge but who simultaneously delegate tasks as an example of the performance paradox, and we see a comparable paradox for risk managers in banks. The risk managers’ primary role is to keep risks under control and to ensure compliance with external regulations, but they are not directly in charge of the transactions that create the risks. In the context of the TLOD model, their role is to engender behavioural change within the front office and encourage bankers to take direct responsibility for risk management. However, the scope to achieve this is limited if, as our evidence suggests, regulatory arbitrage and internal remuneration systems are actively discouraging such behaviour.

In seeking to change trader behaviour, a risk manager or product controller needs to be able to exercise some power over the front office staff, but this may be difficult in practice. The front office typically has more power than the back office/risk management function because of resource dependency which creates a coercive institutional pressure (Carpenter & Feroz, 2001):

“There is a relative hierarchy – traders are top of the pile, followed by the risk and compliance guys. Back office guys are always answering up to sales and business people.”

Interviewee 9 (Corporate Banker)

The imbalance of power between internal controllers and front office staff was clearly evident to Paul Moore, head of group regulatory risk in HBOS from 2002-2005. In evidence to the UK’s Treasury Select Committee, he observed that “being an internal risk and compliance manager at the time felt a bit like being a man in a rowing boat trying to...
slow down an oil tanker” (Jones, 2009: “The Moore Memo”). In a review of the governance lessons to be learned from the global financial crisis, the OECD (2009, p.12) noted that “the lower prestige and status of risk management staff vis-à-vis traders” played an important role in preventing the control functions from exercising the critical scrutiny necessary for their role.

Our evidence suggests that the lack of authority granted to the risk control function to effectively challenge front line staff is a direct consequence of the failure of the TLOD model to address the performance paradoxes faced by both the bank and individual staff. If revenues are prioritised, then the front office staff will dominate decision making, and risk and control become an exercise in compliance rather than effective risk management. Furthermore, the performance paradox then gives rise to belonging and learning paradoxes.

5.3 Belonging and Learning Paradoxes

A paradox of belonging is defined as a situation in which individuals face a conflict between their personal and social identities in the workplace (Kreiner et al., 2006). Luscher and Lewis (2008) extend this definition by suggesting paradoxes of belonging may also arise when staff are simultaneously members of groups with different social identities. Within financial institutions, as organisations become more multinational with numerous reporting lines for each manager, the belonging paradox generated by conflicting social identities becomes potentially more acute – do individuals favour the business unit or the controlling function in the way they do their job? The conundrum is clearly delineated in the following observation:

“Business unit controllers (e.g. product controllers) belong to the financial controller function, and also support directly the business unit managers. Business unit controllers have dual reporting lines and close links to both back office and front office groups which could create conflicting goals.”

Interviewee 4 (Compliance Officer)

Business unit controllers face the challenge of potentially confusing and conflicting reporting lines. Their business unit evaluates them on investment returns, yet in reporting to the financial controller, the focus will be on risk management. A business unit controller belongs simultaneously to the business unit team, the business control team
and the financial control team, each of which may have differing social identities, mindsets and perspectives. The same conflict of loyalties applies to all risk managers, middle office and back office staff with reporting lines both to their back office managers and the business unit heads responsible for their performance evaluation.

The challenge for product controllers is further exacerbated by differences in the knowledge and information levels between front and back offices. Such knowledge gaps represent a learning paradox that arises out of a continually evolving environment in which new products and regulations regularly appear:

“In one bank, the mechanics of CDOs (collateralised debt obligations) were not documented, and the back office and product controllers did not understand the product.”

Interviewee 4 (Compliance Officer)

If back office staff do not understand the products being sold or traded by the bank, then they cannot effectively control the associated risks. In Bear Stearns, Goldstein and Henry (2007) found that accountants conceded to traders in the valuation of complex derivatives, even though the traders had created and/or sold the products. Similarly, in announcing a £5.6 million fine on Credit Suisse, for the mispricing of asset backed securities by traders, the FSA commented on the inability of risk management staff to impose effective controls (FSA, 2008). The problem has, rather ironically, been aggravated by improvements in IT systems which have worked in favour of the traders, although IT has also helped risk management controls in other respects.

“Over the years, improvements in IT systems have enhanced risk management controls in some areas. For example, primitive treasury systems in the past hindered profit/loss reconciliations for split hedges, and marking to market of foreign currency swaps. These old systems have been replaced by sophisticated Murex and Summit systems that contain front office to back office modules, allowing straight through processing….. However, such improvements in technologies only lead to more complex products being developed. Complex products lead to complex systems which create power differences between people who know and those who do not know the systems, and introduce significant unknown risks and uncertainties.”

Interviewee 4 (Compliance Officer)
Additionally, efforts to reduce costs by outsourcing basic financial functions have also created new learning paradoxes and increased risks.

“Financial reporting problems have been compounded by the outsourcing of profit/loss production and reporting to low-cost developing countries. The distance and communication barriers, coupled by differences in work attitudes and risk appetites create risks in the financial reporting processes.”

Interviewee 12 (Product Controller)

Another example of inequality of understanding between front and back office staff relates to the valuation of trades in illiquid and complex products, which originate primarily from traders. Valuation quotes for illiquid products may come from a single broker, making them subject to manipulation based on personal relationships between the trader and the broker and the incentives promoted by the reward/compensation structure. Under the fair value accounting rules detailed in IFRS13, when there is no active market a product’s valuation must be marked to model i.e. based on observable market inputs and/or recent market transactions. In the case of highly illiquid products, however, the availability of relevant input data may be very limited. In practice, the valuation is first determined by the traders before going through an independent price verification process by the product controllers. This process creates a learning paradox as the valuation is largely driven by the traders and it is difficult for product controllers to challenge or override the traders’ valuation as the latter have more knowledge of the products. Uncertainties in risk management come from risks of errors in model, input and parameter specifications, all areas where the primary expertise lies with traders. Our interviewees identified a number of different ways in which the banks and the compliance and control staff have responded to this paradox. At the organisational level, there is evidence of the introduction of structured processes for the resolution of disputes between traders and controllers.

“In terms of structure, there is an escalation process for a valuation issue to be raised to the Head of Trading desk. In case an issue has to be escalated to the Head of Global Markets, the Head of Product Control will talk to the Head of Global Markets. For distressed prices, there is an internal forum to determine the prices to use (within a range from illiquid to modelled prices), and the product controllers can defend their valuations by relying on prices approved by this forum.”
Interviewee 4 (Compliance Officer)

This adapting response from the bank recognises the paradox and seeks to provide a mechanism for its resolution by increasing the power of the control function relative to the front office. This can also be addressed by seeking support from other risk management functions.

“Within the banks, product control can be supported by the market risk function in their control over the front office. For example, the product control and risk management teams worked together on the move to OIS (overnight index swap) rates after the Libor fixing issue. The risk management team is knowledgeable about market risks, although they lack an understanding of market nuances/practices.”

Interviewee 6 (Internal Auditor)

Product controllers may seek to eliminate the learning paradox by increasing their personal expertise, to enable them to challenge the traders more effectively:

“For example, I encountered a situation of short term hedges using Korean Treasury bill futures and learnt that valuation of Treasury bills differs from bonds. I enrolled in a Masters of Applied Finance program to bridge this knowledge gap. I feel that a product controller needs to use evidence and audit trails to support his/her number while discussing with traders. I carried out an analysis of one-day $1m profit in an equity derivative linked to the Tokyo index and convinced traders to accept a $1m profit reduction.”

Interviewee 4 (Compliance Officer)

Even if the theoretical knowledge gap can be mitigated by better training of back office staff, the traders are still ahead of the curve by virtue of their closeness to the business environment. The traders can claim to know the business and have more relevant ‘market’ prices for product valuation in financial reporting.

The third line of defence within the banks is the internal audit function, but it was suggested to us that staff here also faced knowledge gaps, perhaps because they are more distanced from the businesses and so have greater difficulty in understanding the risks being taken.

“Internal auditors are in a difficult position, because others refrain from teaching the internal auditors. The problem of a lack of systems knowledge in auditors is more
“critical than the lack of product knowledge as the latter can be learnt based on term sheets.”

Interviewee 4 (Compliance Officer)

If product controllers and internal audit are limited in their capacity to challenge the traders, then it is possible that the external auditors may be able to do so, but we were told that they too suffer from a knowledge gap.

“Auditors find it difficult to understand the complex systems of banks, and lack system knowledge. For example, components of a structured product are processed via different systems. Auditors who have never implemented a bank system will not understand the systems, black-boxes to them. They merely tick off reports. The IT auditors review access security, but not data integrity.”

Interviewee 4 (Compliance Officer)

The increasing dependence by external auditors on information provided by internal audit perhaps helps to compound this learning paradox. If internal audit do not understand the product innovations then they will not make external audit staff aware of the issue, and the paradox escalates through the layers of defence. All of the above responses to a knowledge gap indicate that there is acceptance of the presence of a learning paradox, and recognition of the need to adapt systems accordingly. However, its ultimate persistence in the face of such recognition highlights an ongoing risk for the bank. Traders appear to be capable of abusing their relative knowledge advantage and the TLOD model does not help to eliminate the problem. Additionally, external auditors, who are not part of the TLOD, are suffering reductions in their jurisdictional expertise (see Smith-Lacroix, Durocher, & Gendron, 2012; Woods, Humphrey, Dowd & Liu, 2009) despite some suggestions that they could provide a fourth line of defence (FSI,2015).

6. Discussion and Conclusion

The empirical evidence and analysis presented in this paper stands as a challenging assessment of the capabilities of a risk management function within the banking sector built on a regulatory driven (Basel, 1998) split between front and back office functions and the institutionalisation of what has come to be referred to as the TLOD model. Despite the heralded or, at least, typically presumed value of apportioning risk management responsibilities across different ‘lines of defence’, we find that risk
management in banks is plagued by a number of underlying, connected paradoxes that challenge and potentially seriously limit the capabilities and overall effectiveness of such a function.

The paradoxes originate at the organisational level and cascade down to the individual staff working in formal compliance and control activities. They are exacerbated by fundamental differences in the perceptions and understanding of risks across the front and back offices (Wahlstrom, 2009) which create tensions in their interactions. Whilst prior literature (GAO, 2000; Power, 2009; Frigo & Anderson, 2011) has stressed the importance of ‘tone at the top’ and risk cultures, as factors influencing the effectiveness of internal controls, our study demonstrates the need to look more closely at staff engagement lower down the organisational hierarchy and their respective capability to facilitate and/or hinder the management of risk. The TLOD model of risk management, which defines front office staff as the first line of defence, appears to have been adopted in principle but not in spirit. Front office staff continue to engage in grey market practices and the gaming of regulations, confirming evidence from the literature that staff can, and will, find ways to negate the constraints imposed by risk management systems (Bealing, 1994; Westphal & Zajac, 2001; MacLean & Benham, 2010; Sandholtz, 2012; House of Lords, 2013).

Overall, whilst the TLOD model has formally spread responsibility for risk management across different organisational lines, it has simultaneously failed to impact on institutional hierarchies which continue to place traders above risk and compliance staff in terms of their presumed value to the organisation. Our findings clearly indicate that at the heart of the relationship between the revenue generating and control functions lies a fundamental imbalance of power, characterised by traders having both greater status and product knowledge. This finding echoes earlier commentaries on the banking sector shortly after the outbreak of the global financial crisis (e.g., see Kirkpatrick, 2009; FSA, 2008; Société Générale, 2008; Jones, 2009). More recent studies have also been explicitly critical of the application of the TLOD model, with the UK Parliamentary Commission’s (House of Lords, 2013) report on banking standards, for example, highlighting both its practical inability to disturb existing power structures and the misplaced operational emphasis on presenting a formal appearance of a well-functioning risk management that is not subjected to critical testing and assessment: “The “three lines of defence” system for controlling risk has been adopted by many banks with the active encouragement of the regulators. It appears to have promoted a wholly misplaced sense
of security. Fashionable management school theory appears to have lent undeserved credibility to some chaotic systems. Responsibilities have been blurred, accountability diluted, and officers in risk, compliance and internal audit have lacked the status to challenge front-line staff effectively. Much of the system became a box-ticking exercise whereby processes were followed, but judgement was absent” (House of Lords, 2013, p.141).

Across the banking sector there appears to be a residing sentiment that if the ‘proper’ splits in risk management responsibilities could be secured and levels of independence and authority suitably established and respected, then risk management systems will function well. A deeper level of reflection would point more towards conceptual rather than operational failings. In this regard, our empirical evidence is strongly suggestive of the view that the functional splitting of risk management responsibilities, when coupled with organisational recruitment, remuneration and performance management systems that encourage revenue driven mind-sets in the front office, appears operationally incapable of delivering a tightly coordinated organisation risk management system. As such, the study lends considerable support to the suggestion that the regulatory demand for an independent risk function may actually “be a significant barrier to an ambition to expand the risk function footprint within the business” (Power et al., 2014).

Our evidence demonstrates that, in failing to resolve the core market-regulatory paradox (and just shifting it from the broader organisational to the more specific personal level), functional splitting combined with the TLOD model has served to reinforce the paradoxes and tensions that challenge, if not critically undermine, the effectiveness of risk management. We therefore conclude that neither regulations nor the TLOD model for bank risk management are as effective as some might like to believe. We conclude that there are strong analytical grounds for questioning the current adequacy of institutional responses to risk management failures in the banking sector and raising the real possibility that existing, regulatory and industrially endorsed, models of risk management are fundamentally flawed.

In closing, we acknowledge the limitations of our study, both in terms of the number of interviewees and the prominence of interviewees working in risk and control, but believe that our paper offers important insights of general significance across the banking sector. There is still evident scope for further research to improve our understanding of the “key issues (that) are played out at the interface between what are called the first and second lines of defence (Power et al., 2014)”. However, and most
crucially, the paper’s findings emphasise the importance of ensuring that future research in this area directly addresses the core premises, concepts and belief systems on which a burgeoning risk management ‘empire’ has been built. Gendron et al. (2016) have recently highlighted various ways by which risk management has been protected from systemic questioning, focusing particularly on the importance of assumptions regarding ‘risk reliability’. This study reinforces the importance of such thinking, by explicitly indicating that a collection of paradoxes lie at the core of risk management is, the resolution of which lie not in systems per se, but also personal interactions, beliefs and broader organisational workings. We look forward to reading the insights of future researchers on such matters.
References


PwC (2012). *Black swans turn grey – the transformation of risk.* UK: PwC.


Table 1: Details of interviewees

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