



Supervision of Behaviour and Culture

Foundations, practice & future developments

DeNederlandscheBank

EUROSYSTEEM

Supervision of Behaviour and Culture

Foundations, practice & future developments

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Introducing the team of supervision of behaviour and culture and the authors

Foreword

Dear colleague supervisor,

Thank you for taking an interest in this book. The result of thorough research driven by conviction, it captures the views and experiences of many men and women who believe it is time to considerably broaden our take on the financial world.

The scale of the financial crisis erupting in 2008 brought home to us that, in assessing a financial enterprise's health, it no longer sufficed to look just at facts and figures. More than ever were we aware that our supervisory scope should be extended to include the people behind these figures and facts, those that pull the strings. After all: if the ripples created by a pebble thrown into water have a distorting effect, it is not the pebble that should be held accountable, but the hand that threw it.

Acting on the lessons thus learnt, in a few years' time, De Nederlandsche Bank increased its supervisory staff with colleagues specialised in assessing behaviour and culture.

Initially, this new strategy met with scepticism, not just outside our organization, but also internally. Were we not acting beyond our remit and treading on the territory of consultants? And was this not a far cry from facts and figures, which are so blissfully concrete? We responded by pointing out our mission statement, which reads that De Nederlandsche Bank "seeks to safeguard financial stability...", and that in light of that mandate we must keep a close eye on anything that may put this financial

stability in jeopardy. Naturally, this includes a financial institution's behaviour and culture.

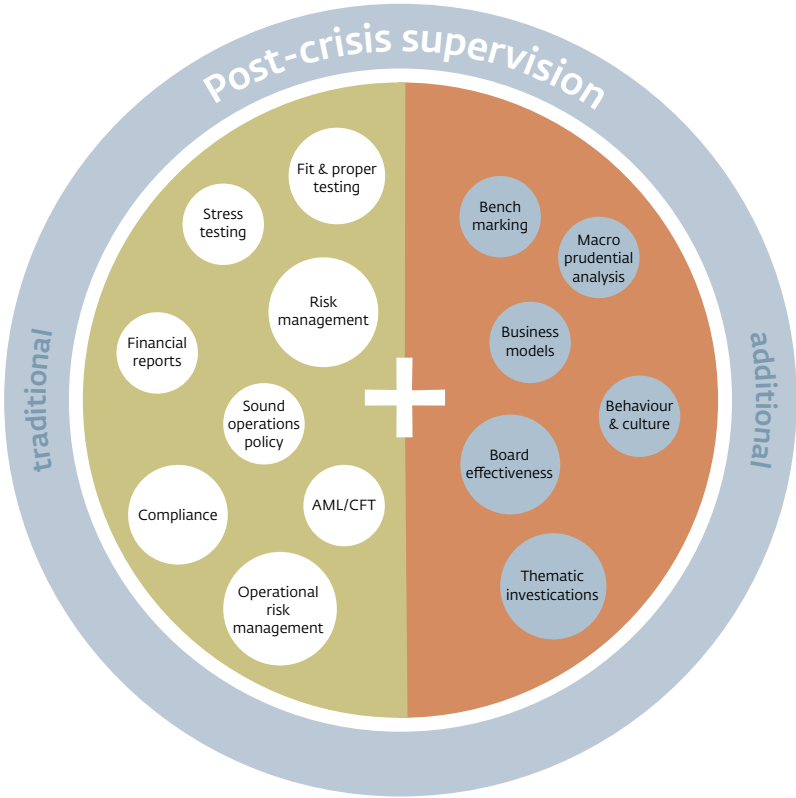
Five years on now, we are happy to report that our endeavours have been increasingly rewarding and that some countries are following suit. The initial scepticism has gradually made way for genuine appreciation, both from institutions whose behaviour and culture we examine and from our supervisory colleagues at home and further afield.

In short, there is every reason for us to continue on this path and for supervision on behaviour and culture to be further explored. The latter preferably not just by us, your colleagues at De Nederlandsche Bank, but together with you. We therefore invite you to participate in this exploration, by sending in your comments on this book, and by sharing your experiences and thoughts. In other words: may the ripples created by the pebble we have thrown, reach you!

Yours sincerely,

Frank Elderson

Executive director



Rationale for supervision on behaviour & culture

Model & Basic Assumptions

Focus on Group Effectiveness

Supervisory Approach & Methodology

Focus on Change

- **Part I**
The Foundations
- Chapters 2-4
- **Part II**
Our Practice
- Chapters 5-10
- **Part III**
Future Developments
- Chapters 11-12

Future Developments

Why this book?

1.1 A book for our colleagues

Since the financial crisis, behaviour and culture have been important issues for financial institutions and their internal and external supervisors. In 2010¹, DNB initiated, developed and implemented a new supervisory approach that focuses explicitly on behaviour and culture risks. Now, in 2015, we celebrate the fifth anniversary of our supervision of behaviour and culture. Internationally, there is considerable interest in our behaviour and culture supervision, both from the financial sector and its supervisors in other countries and from other sectors. The questions we get asked by supervisors include: how do we start this type of supervision, what tools and theoretical background should we apply, what experts should we hire, etc.

This book aims to address those questions and answer them where possible. We have published it because we would like to show you how we work and why we work the way we do, and inspire others to explore this new type of supervision. We look forward to reading or hearing your comments and suggestions. We have built a great deal of expertise and hope to continue doing so, together with as many supervisory authorities as possible.

We are also working on a series of brochures about the same theme, which are aimed at the sector itself. We do so because we wish to be transparent about our expectations regarding the sector and the outcomes of our supervisory work, by providing examples of good and bad behaviour and

¹ Based on DNB's policy vision "The seven elements of an ethical culture" (2009).

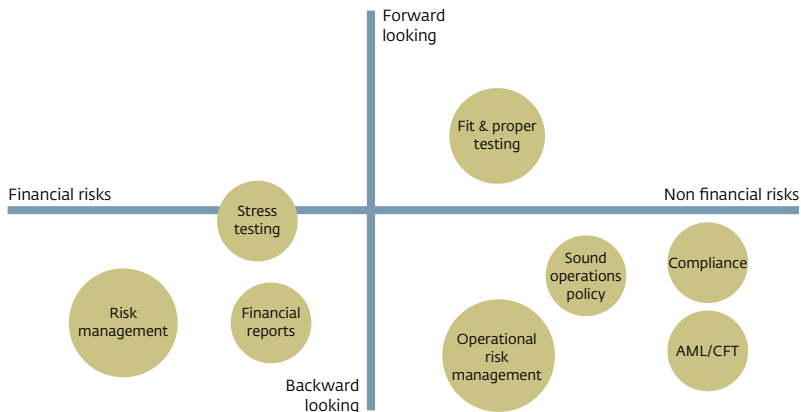
explaining our focus. Two brochures have meanwhile been published: *Leading by Example* (2013) and *Capacity for Change* (2014).

1.2 The case for supervision of behaviour and culture

The crisis has shown that one of its causes was not so much that governance structures were inadequate, but that board and management behaviour within those structures was below standard. After all, it is the people who determine a company's performance. Even when everything seems OK in terms of financial performance, risks relating to behaviour may already be visible. Behaviour has a certain predictive quality with respect to future financial performance, which is why early intervention may prevent future problems.

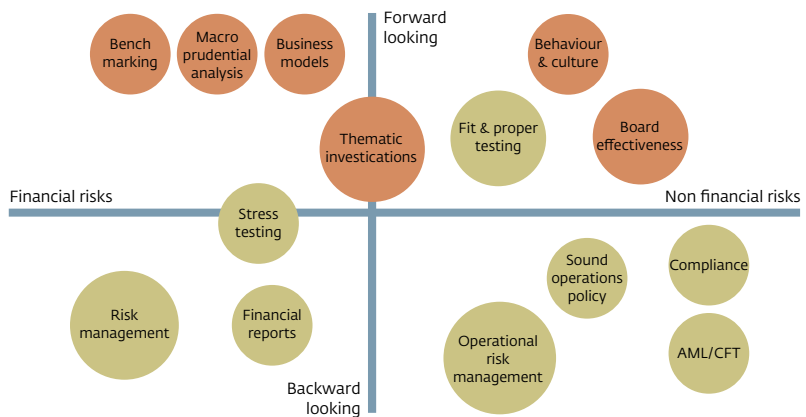
We therefore decided we should find other answers. Five years ago, the supervision of the financial sector could be illustrated by the diagram below – it was mainly backward-looking, focusing on financial risks and systems, and on controls.

Figure 1.1 Pre-crisis supervision (Kellermann, De Haan & De Vries, 2013)



We subsequently explored the quadrants in the diagram that were relatively empty, adding the missing pieces of the puzzle. In order to do so, we examined the fields of behavioural science, based on classical theories from psychology and change literature. This made the picture a lot more complete:

Figure 1.2 Post-crisis supervision (Kellermann, De Haan & De Vries, 2013)



In the above diagram, we can see the result of a shift towards a more forward-looking approach and, overall, a more complete assessment of risks, not only financial but also non-financial risks. Newly added focus areas include business models, board effectiveness, behaviour and culture. Furthermore, we have added different methods, such as benchmarking and in-depth thematic reviews. These changes, which are both methodological as well as content-driven, should enable us to detect problems in the financial sector as a whole or individual institutions at an early stage.

Together, these innovations are an adequate response to the lesson we learned from the financial crisis, which is that we should be a prescriptive and authoritative supervisor, in dialogue with the financial sector.

1.3 Five years of experience have had positive effects

Since we started this type of supervision in 2010, we have developed and tested a method for supervising behaviour and culture at financial organisations that has proved to be successful. We have been able to identify and assess risks relating to behaviour and culture, and – in most cases – mitigate them.²

The response from the sector has been predominantly positive, as was shown in a study conducted by an independent Dutch-based consultancy firm that evaluated our supervision. The study involved board members of nine financial institutions, leading experts and other stakeholders, such as the Ministry of Finance. Overall, the evaluation cited positive reactions to our supervision of behaviour and culture. Especially and without exception, the evaluation drew the following conclusions with regard to our supervision of behaviour and culture:

- Supervision is professional and respectful, and it demonstrates DNB's expertise in the field of behaviour and culture.
- Experts unanimously appreciate DNB's methodology.
- DNB has developed an original and effective supervision method.
- In particular, the way it operationalises 'soft' behavioural and cultural aspects into measurable variables is highly valued.
- This approach guarantees concrete conclusions and recommendations.

1.4 More than 50 assessments conducted since 2010

Since the start of supervision of behaviour and culture in 2010, we have conducted 52 assessments (see Table 1.1). We held them at banks, insurance

² This book cites many examples, all of which stem from our own experience. Behind every example lies a real-life case, which is why we have chosen to anonymise all examples. It is important for building trust between the financial sector and supervisors that we do not share supervisory information. This means that, regrettably, we are unable to present detailed case studies.

companies, pension funds and trust offices, most of which are located in the Netherlands. The financial organisations we assessed differ in size, but those that have a significant impact on the economy and financial stability dominate the population, as our supervision is risk-based. They include the large and significant banks and insurance companies.

Table 1.1 Number of supervisory assessments on behaviour and culture conducted since 2010.

Financial institutions	Number
Banks	20
Insurance companies	17
Pension funds	11
Trust offices	6
Total	54

The reasons for conducting supervisory assessments of behaviour and culture vary. They include observations made within the context of regular supervision that give rise to concerns about behaviour and culture, and other (financial) results or supervisory problems indicating that an organisation has issues with regard to behaviour and culture.

In addition, we have decided to conduct thematic reviews on behaviour and culture. They focused on specific topics, such as decision-making, assessing it simultaneously at various financial organisations. The topics we have addressed so far are decision-making (2011), board effectiveness (2011-2012), behaviour and culture (2012-2013), capacity for change (2014), root cause analysis (2015), and risk culture (2015). Chapter 4 deals more extensively with the various types of assessments we conduct.

Boards show increased awareness of their group dynamics and the influence of behavioural patterns on the business. This awareness is needed for sustained behavioural and culture change. We have observed the following changes:

- Supervisory boards³ hold management boards increasingly accountable for behaviour and culture in their organisations.
- Supervisory boards address sensitive board issues more directly, intervening if board dynamics are ineffective.
- Changes can be seen in the way interests are discussed and decisions are made.
- Existing governance structures are reinforced through behavioural interventions, for example by organising countervailing power.
- Countervailing power is enhanced through increasing and earlier involvement of key control functions, and by reinforcing the role of independent directors on the board and of the second and third lines of defence.
- Culture change is increasingly considered the responsibility of the board, rather than of HR.
- More focus is placed on implementing culture change, rather than on making plans.
- In a number of cases, our supervision has had governance and staffing consequences, leading to the dismissal of board members.

An important side effect of supervision of culture and behaviour has been that supervisors acquire a more comprehensive overview of the root causes of many supervisory issues pertaining to the institutions they supervise. This increases their options for intervention and makes their interventions more effective.

³ Dutch financial organisations have a two-tier board structure, consisting of a management board (comparable with executive directors in a one-tier system) and a supervisory board (comparable with non-executive directors). Behaviour and culture supervision has focused mostly on the management board level, which is why the term 'board' in this book refers to the management board or executive management.

1.5 Results of management assessments

The majority of our 52 assessments addressed the organisations' senior management level. We mostly dealt with management boards and in some cases also assessed supervisory boards. The aim of our assessments was to identify patterns in decision-making, leadership, communication, group dynamics and mindsets of the management boards, assess risks to the financial soundness and stability which these patterns pose, and mitigate these risks.

We published the results of these board-level assessments in our report entitled 'Leading by Example – conduct in the board rooms of financial institutions' (2013). They show that, in general, members of the boards of financial organisations lack attention to and awareness of their own behaviour and the group dynamics that influence their results.

Other risks that these board-level assessments have revealed include:

- (a) dominant CEO leadership and docility of board members, or senior management blocking the voicing of constructive dissenting opinions,
- (b) unsatisfactory adherence to strategic or other objectives, leading to risky decisions that result in financial loss, and
- (c) informal decision-making that renders the formal organisation 'obsolete'.

More than half of the boards we assessed showed serious problems with regard to their board culture. In the confidential supervisory reports that we issued to the organisations, we reflected on behaviour in the boardroom and the effectiveness of governance, citing both effective aspects and risks. The following are examples of typical risks relating to behaviour and culture:

- Decisions are insufficiently challenged at board level, which impedes the voicing of constructive dissenting opinions and sound decision-making,

due to dominant CEO leadership and a lack of countervailing power in the board or the failure to involve relevant disciplines.

- Unsatisfactory adherence to strategic or other objectives and 'herd behaviour' leading to risky decisions that result in financial loss.
- The existing culture impedes the realisation of a new strategy.
- A lack of self-reflection, which impedes organisational learning.

1.6 Results of change capacity review

Capacity for Change, our thematic review of 2014, focused on the ability of financial institutions to implement major changes. The financial sector is in the process of making major changes that are necessary to achieve a stable, financially sound sector that exercises due care when providing financial services to customers. As these changes are related to the missions of both the Netherlands Authority for the Financial Markets (AFM) and DNB, we decided to conduct a joint study into the sector's ability to implement these changes. We investigated capacity for change at several banks and insurance companies, looking at aspects such as comprehensive cultural change programmes, or the introduction of new operating procedures in specific departments. Our aim was to bring into focus recurring success factors and impediments.

The results of the Capacity for Change thematic review were published in our report entitled 'Capacity for change in the financial sector' (2014, www.dnb.nl). We found a genuine willingness to change: employees working at all levels in the financial sector appeared highly motivated to bring about successful change. The leading figures at the financial institutions have a widely shared sense of the urgent need to make changes now – and changes are actually being made. One of the risks we found is that priorities set in the numerous challenges currently facing financial institutions are not sufficiently clear.

1.7 The three parts of this book

After five years of behaviour and culture supervision, we have decided to publish this book to show you how we work and why we work the way we do in the supervision of behaviour and culture. The book describes our experience and foundations and shares our results. We hope it inspires you, our fellow supervisors in the financial sector, to explore behaviour and culture as an area of supervision.

This book is structured in three parts. Part I explains our rationale, basic assumptions and supervisory methodology. Part II describes the four standard survey subjects that we address in most of our inspections: decision-making, leadership, communication and group dynamics. These four factors are predominant in our inspections on group effectiveness. Following the discussion of these factors, we present two additional areas of interest, on which aspects of behaviour and culture always have a major impact: capacity for change and culture change.

Part III looks forward. We strongly believe that in the next five to ten years two major changes will occur in the financial industry. The internal supervisory mechanisms will play an increasingly larger role. At the same time, an increasing number of organisations have begun to take an interest in error management. We believe that these two areas have so far not been adequately studied, which is why we enabled two supervisors in our team to work on their PhDs on these subjects. In Part III, they describe their research and the preliminary results, offering a glimpse of potential future developments.

We hope this book contributes to the growth of supervision of behaviour and culture, so that it reaches a higher maturity level. We welcome your comments and suggestions.

Reference

DNB (2009). *The seven elements of an ethical culture.* Amsterdam: www.dnb.nl

Kellermann, A.J., De Haan, J & De Vries, F. (2013). *Financial Supervision in the 21st Century*, Kellermann, A.J., De Haan, J & De Vries, F. (Eds.). Berlin Heidelberg: Springer-Verlag.

Rationale for supervision on behaviour & culture

Model & Basic
Assumptions

Focus on Group
Effectiveness

Supervisory
Approach &
Methodology

Focus
on Change

Future
Developments

Part I

Foundations

Chapter 2-4



The Rationale for Supervision of Behaviour and Culture¹

2.1 Introduction

In 2013, news of the manipulation of the London Interbank Offered Rate (Libor) went viral. Several banks – including The Royal Bank of Scotland, Deutsche Bank and Rabobank – were involved in the illegal fixing of this interest rate, which serves as a reference rate for many financial products worldwide, such as mortgages. Clearly, manipulating the Libor rate can negatively impact the reliability of financial markets. The media published explicit emails between employees, creating an extremely embarrassing situation for all banks involved. Their reputations, as well as the reputation of the banking sector as a whole, suffered significant damage. On top of that, they faced extensive fines: RBS was fined €260 million, Deutsche Bank €259 million and Rabobank €774 million. After the financial crisis, this reputational damage led to another decline in trust in the financial sector, and its financial repercussions make the Libor scandal illustrative of the way behaviour within a financial institution influences its (financial) performance.

The banks involved emphasised that the scandal resulted from individual misbehaviour. To eliminate this ‘behavioural problem’, the banks fired or disciplined the employees concerned and distanced themselves from their behaviour. For instance, in one of Rabobank’s public reactions²,

¹ The author has adapted the texts of section 2.1 and 2.2 specifically for this chapter. They are based on a broader research project with Professor Naomi Ellemers, which aims to clarify how banks can work to improve their organisational culture by linking psychological insights and knowledge with their practice.

² The response of Rabobank in this example was public and directly provided to the media. We refer to the press release ‘Rabobank settles Libor and Euribor Investigations on <https://www.rabobank.com/en/press/search/2013/libor>.

it characterised the employees as a group of 'rotten apples in the barrel', implying that it had solved the problems by removing these individuals. Although it is important that in case of misbehaviour within an organisation disciplinary actions against the relevant employees are taken, aspects of the cultural and organisational context that made this misbehaviour possible should also be emphasised. The manipulation of the interest rate by certain employees might be connected to (or caused by) such problems as faulty leadership, misguided strategic choices, ineffective performance management or negative effects of incentives. Such behavioural and cultural aspects could have fostered the manipulative behaviour, which led to the resulting impairing events. The fact that the Libor manipulation became publically known five years after 2008, the year that is generally considered the start of the economic crisis, suggests that these behavioural and cultural aspects that foster misconduct have remained.

A large body of research shows that the behaviour and culture of a financial institution influences its financial performance (De Haan & Jansen, 2011; DNB Financial Stability report 2015³) – as illustrated by the Libor example. Therefore behaviour and culture are not only essential for the entity itself to consider but are also key components for financial supervision. The next section elaborates on the necessity for financial supervisors to assess behaviour and culture as part of their prudential supervision.

2.2 The importance of supervising behaviour and culture within financial institutions

De Nederlandsche Bank (DNB) is responsible for prudential supervision of financial institutions in the Netherlands. Since 2010, DNB's supervision also takes account of behavioural patterns and cultural aspects of these

³ DNB Financial Stability report 2015, www.dnb.nl.

institutions (Nuijts & De Haan, 2013). The attention for behaviour and culture in supervision is based on three premises.

First premise: increasing rules and regulations is not enough

The first premise, underlying DNB's supervision of behaviour and culture, is that an increase in rules and regulations alone is not enough to prevent a financial crisis. After the fall of Lehman Brothers in September 2008, which is often marked as the event that triggered the financial crisis, the policy response was a massive increase in regulation and stricter supervision. While this response was clearly necessary, we know from previous crises that an increase in regulation has limitations and creates risks and problems of its own. In other words, while an increase in rules and regulations contributes to the perception of being in control, there are limits to what this approach can achieve.

Much of the analysis of the financial crisis and its consequences points to human behaviour as one, or the key, driver in what went wrong. The crisis has taught us a hard lesson about several weaknesses in our financial system. It has revealed that rules, primarily capital and liquidity requirements, were not sufficient to preclude the excessive risk-taking that ultimately contributed to the financial crisis. Former Fed chairman Alan Greenspan put it this way: "The Corporate scandals of recent years have clearly shown that the plethora of laws of the past century have not eliminated the less savoury side of human behaviour. Rules cannot substitute for character". In recent years, several international reports⁴ have emphasised behavioural issues in the performance of the financial sector. For instance, the Group of Thirty states in their 2011 report: "Supervisors must focus on the demonstration of effective behaviours, not just on structural matters such as board composition and mandate" (Hoening, 2011).

⁴ See also, for instance, the 2012 FSA's report into the failure of RBS, <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmtreasy/640/640.pdf>, and the FSB guidance on supervisory interaction with financial institutions on risk culture, http://www.financialstabilityboard.org/wp-content/uploads/140407.pdf?page_moved=1.

Second premise: connection with public trust and financial stability

The second premise that forms the basis of DNB's supervision of behaviour and culture is the strong relation between the perceived behaviour and culture of financial organisations, and the public trust in the financial sector. Trust is the foundation on which our financial system is built. It is a key driver for a stable economy and thus for the work of DNB. The crisis has left many people with a sense of social discontent regarding the financial sector. And the general public's trust in banks and other institutions has fallen⁵ (Cruijssen, van der et al., 2013; Jansen, 2014). This is having a negative impact on the real economy (Jansen et al., 2013). The financial sector is facing the major challenge of regaining trust and confidence. Financial institutions will have to work (and many already are) on achieving a culture of integrity, a sound remuneration policy and sustainable earnings. Trust is an essential ingredient. And integrity (which is also evidenced by a sound and solid business culture) is an important prerequisite for public trust in the financial sector. The management bodies and senior management of financial institutions are expected to foster a culture where there is sufficient attention for the client and for risk, and where harmful and illegal activities are not tolerated (see DNB's Supervisory Vision 2014-2018). In short, to strengthen public trust in the financial sector, soundness and integrity of the business operations of the financial institutions are important pillars of the financial system. The behaviour and culture within financial institutions must contribute to strengthening this soundness and integrity. Therefore, DNB considers them relevant for prudential supervision.

Third premise: behaviour and culture are part of sound business operations

The third premise, which is directly related to the second premise, is that behaviour⁶ and culture are integral parts of the bigger organisational picture of a financial institution. The foregoing implies that, as part of sound business operations, financial institutions need to develop an

⁵ www.financialtrustindex.org

⁶ The most visible manifestation of culture is behaviour – see also Chapter 3, including references.

integrated and institution-wide view and mission statement (to be implemented by means of policies, internal communication, exemplary behaviour, training etc.) on the behaviour and culture within the institution as well as effective processes to identify and manage behaviour and culture risks. “The overriding responsibility for improving the behaviour of banks must lie with the leadership of the institutions themselves, operating within the framework set out by the regulators. It is for them to define the values and purpose of the banks which they lead, to appoint and promote people who are aligned with its values, to decide which types of business they are happy to accept and which to turn away, and to do everything in their power to make sure that the tone set at the top reaches all the way down through these often very large organisations”⁷.

As supervisor, DNB must be able to address behavioural and cultural risks explicitly and professionally as part of the supervisory program. Among other things, the foregoing means that DNB needs to have suitable prudential⁸, legal and (organisational) psychological methodologies and techniques to perform its tasks as the prudential supervisor of financial institutions in the Netherlands.

2.3 The legal framework for banks under Dutch law ^{9 10}

Under Dutch law, the legal framework for banks under which they are required to integrate behaviour and culture into their business operations is the Dutch Financial Supervision Act, which states that they must

⁷ Banking Standards Review (2014), p.7.

⁸ Prudential means ‘related to prudential risks’, such as market risk, credit risk, but also operational (including legal) risk.

⁹ The section on the legal framework for banks under Dutch Law is written by Annemarie van Dijk, supervisor specialist at DNB and lawyer.

¹⁰ In this section, the legal framework for Dutch banks is discussed. However, it should be noted that the concepts described are also somewhat applicable to other financial institutions, such as Dutch insurers or pension funds, pursuant to the same or comparable legislation, in each case with due regard to the characteristics of the relevant financial institution.

organise operations in such a way to safeguard controlled and sound business operations¹¹. One area in which behavioural and cultural risks may occur and can have a detrimental impact on business operations, is the governance of an institution. Indeed, robust governance arrangements¹² are needed to safeguard controlled and sound business operations. In this context, reference should be made to the consultative document ‘Guidelines – corporate governance principles for banks’ published by the Basel Committee on Banking Supervision dated October 2014 (item 27): “a fundamental component of good governance is a demonstrated corporate culture of reinforcing appropriate norms of responsible and ethical behaviour.”

The EBA (European Banking Authority) has issued guidelines on internal governance¹³. These guidelines cover topics like ‘corporate structure and organisation’, ‘duties and responsibilities of the management body’¹⁴ and ‘risk management’ (including risk culture and risk management framework). In broad terms, achieving effective governance involves a combination of adequate ‘design, structures and processes’, consisting of elements such as an adequate organisational framework¹⁵, together with a clear allocation of responsibilities and adequate policies and procedures, qualified managers and other employees as well as accompanying

¹¹ See article 3:17 of the Dutch Financial Supervision Act.

¹² Robust governance arrangements include a clear organisational structure and well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks institutions are or might be exposed to, adequate internal control mechanisms, including sound administration and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management. See article 74(1) Capital Requirements Directive IV (‘CRD IV’, Directive 2013/36/EU). For the Netherlands, article 74(1) CRD IV is considered to be implemented in article 3:17 of the Dutch Financial Supervision Act. Also, on governance, we refer to article 88 and 91 CRD IV.

¹³ In the EBA Guidelines on Internal Governance (GL 44, issued pursuant to article 74(3) in connection with article 74(1) and 74(2) CRD IV, the ‘EBA Guidelines’), please see II Background and rationale, paragraph 30. According to these guidelines, internal governance includes all standards and principles concerned with setting an institution’s objectives, strategies, and risk tolerance/appetite; how its business is organised; how responsibilities and authority are allocated; and how internal control is organised. Internal governance also encompasses sound IT systems, outsourcing arrangements and business continuity management.

¹⁴ The management body is meant to have a management and supervisory function, either achieved by a unitary or a dual board structure (see explanatory note to guideline B 10 (management and supervisory functions of the management body)).

behaviour and culture (social processes) that is suitable and transparent.

For example, the EBA Guidelines require that the management and supervisory function of an institution's management body shall interact effectively. The management function proposes the direction for the institution, ensures the effective implementation of the strategy and is responsible for the day-to-day running of the institution. The supervisory function oversees the management function and provides advice¹⁶. In this context, the supervisory function should be ready and able to challenge and critically and constructively review propositions, explanations and information provided by members of the management body in its management function¹⁷.

The requirement that management must be 'able to challenge and review decisions of the management body in its management function critically in a constructive manner' means that on the one hand the financial institution must ensure that the management body (both management and supervisory function) is adequate in terms of 'design, structures and processes'. This refers for example to adequate size and composition (including expertise) of the management body. Members of the management body are able to dedicate sufficient time to the management body's activities, the roles and responsibilities are clearly defined and allocated, and adequate information is obtained in a timely manner. On the other hand, in terms of behaviour and culture ('social processes'), the management body in its supervisory function for example needs to (i) take a more independent and objective approach and to defend its points of view towards the management body in its management function (i.e. 'standing firm'), while at the same time critically challenging it,

¹⁵ Structures are, for example, the organisational framework of an institution, its risk management and internal control.

¹⁶ See EBA Guidelines, guideline B 10. Management and supervisory functions of the management body, including the explanatory text.

¹⁷ See EBA Guidelines, guideline B 10. 2.

(ii) create an atmosphere of common interest and use natural authority and tact.^{18 19}

For DNB, the above means that it needs to have suitable prudential, legal and (organisational) psychological methodologies and techniques to be able to assess whether the management body of a bank is indeed interacting effectively.

2.4 DNB's supervision of behaviour and culture

DNB's supervision of behaviour and culture is aligned with its ambition to supervise in a more proactive²⁰ and incisive manner, taking account of qualitative elements alongside quantitative measures. One of the lessons DNB drew from the financial and economic crisis was that supervisory instruments had fallen short in several areas. These deficiencies emerged in both the scope and the substance of supervision. "The trend towards lighter supervision, reflecting developments within the financial sector as well as changed social attitudes, has gone too far. A tighter supervisory framework is needed," DNB writes in its Supervisory Strategy 2010 – 2014.

Traditionally, DNB's supervisory activities concentrated on verifying whether institutions meet the statutory requirements in terms of solvency, liquidity and controlled business operations related to solvency- and liquidity-supervision. After the crisis, this focus has broadened and

¹⁸ See also the Suitability Policy Rule 2012 (Beleidsregel geschiktheid): policy rule of De Nederlandsche Bank N. V. (DNB) and the Netherlands Authority for the Financial Markets (Autoriteit Financiële Markten /AFM) concerning the assessment of the suitability of policymakers as referred to in the Dutch Financial Supervision Act, the Pensions Act, the Obligatory Occupational Pension Schemes Act and the Supervision of Trust Offices Act (Suitability Policy Rule 2012).

¹⁹ As stated, we focus in this example on the supervisory function. It goes without saying that in its management function, the management body also needs to demonstrate suitable and transparent behaviour aligned with its duties and responsibilities.

²⁰ Proactive in the sense that behavioural and cultural risks are addressed to prevent the occurrence of other (including financial) risks.

deepened to a more qualitative assessment of the institution, focussing on integrity, suitability, behaviour and culture of board members, in a forward looking nature, aimed at preventing problems from happening, rather than having to respond to them (Nuijts & De Haan, 2013). In its Supervisory Vision 2014 – 2018, DNB stated that in financial supervision we are more alert to patterns underlying supervisory issues at financial organisations ('connecting the dots'). By supervising cultural and behavioural patterns, DNB gains more insight into so-called root causes of risks within an organisation. This enables DNB to address these root causes and thereby mitigate the risks instead of intervening in each incident and only providing 'symptom relief'. Accordingly, supervision of behaviour and culture increases the effectiveness of supervision and aims to target issues before they can lead to solvency or liquidity problems.

Even though behaviour and culture within a financial institution influence its performance, they are not commonly addressed explicitly by financial supervisors. However, financial supervisors have a responsibility to explicitly put behaviour and culture on the agenda of financial organisations. In the financial context, supervisors are in a unique position to identify behaviour and culture as key risks faced by financial organisations, and to show perseverance in making the containment of this key risk a management priority. And supervisors are independent and free of concerns about continuing relationships with financial organisations, unlike commercial parties, clients and even competitors. Evidently, for financial supervision it is key to address potential risks over the long term. Therefore, behaviour and culture are essential supervisory topics.

2.5 The psychological paradigm

Many say, human beings are rational creatures. We make decisions purely on the basis of logical reasoning and are focused on utility maximisation, being completely informed and able to adequately use this information

to choose the best alternative. This image of who we are – ‘the homo economicus’ (Van Raaij, 1985) – has dominated thinking in the financial sector and economic science. Moreover, mainstream economists have asserted that they shouldn’t be concerned with psychology and building their economic theory on ‘doubtful’ (Van Raaij, 2014, p.12) assumptions about human behaviour, such as simple hedonism that is purely motivated by external stimuli such as pleasure and pain. Even though Adam Smith (1759, 1776) took psychological and sociological factors into account in his work, the latter work of others in the economic field did not.

Timing might explain the rise of the ‘homo economicus’ as regards behaviour in a financial context. Economics developed earlier than psychology (Van Raaij, 2014). Moreover, addressing behaviour as an economic, rational mechanism speaks to our fear of losing control and to our longing for objectivity and certainty. Numbers, figures and statistics feed into the basic human need for control; they tap into the need to reduce insecurity and eliminate non-linear relations. While these are basic human needs, reality illustrates that the human side of our professional lives – including emotions, intuition and irrationality – also play a role in financial markets and institutions.

Since the beginning of this century, the homo economicus paradigm shifted with the advent of behavioural economics and its use of psychological concepts and theories. Behavioural economics is recognised worldwide; it is a rapidly growing academic field with active links to financial practice (see, for example, the extensive and popular work of Dan Ariely, www.danariely.com). This recognition reached a new height when Nobel Prizes were awarded to psychologist Daniel Kahneman (2011) and economist Vernon Smith. The shift in the homo economicus paradigm has led economists and some financial supervisors to start looking at behavioural risks. For instance, the Financial Stability Board’s Consultative Document ‘Increasing the Intensity and Effectiveness of Supervision’ (2013) reasons that “supervision is not only about ensuring compliance with the

rules but also with the spirit.” And “at the crux of this supervisory approach is an understanding, by both the financial institution and the supervisor of the institution’s risk culture, in particular whether it supports appropriate behaviours and judgements within a strong risk governance framework.” DNB’s supervision of behaviour and culture takes these developments into account, and supervises the human element in the performance of financial institutions in a similar way to its supervision of the financial soundness of financial institutions.

Culture and behaviour are essential elements for financial and prudential supervision, since the behaviour and culture of a financial organisation influence its financial and organisational performance (see De Haan & Jansen, 2011, for a review). Organisational culture has been recognised as an essential influential factor in analysing organisations in various contexts. Scholars have focused on its importance in establishing competitive advantages (Barney, 1986; Cameron & Quinn, 2005) and its impact on organisational performance (Gordon & DiTomaso, 1992; Marcoulides & Heck, 1993; Wilkins & Ouchi, 1983). Cameron and Quinn (2005), for example, emphasise that organisations’ success is not only determined by specific external conditions, such as market entry or competitiveness. They conclude that the remarkable and sustained success of some U.S. companies (e.g., Southwest Airlines, Wal-Mart, etc.) “has had less to do with market forces than with company values” (Cameron & Quinn, 2005, p. 4). Organisational researchers have addressed the relationship between culture and effectiveness (Wilkins & Ouchi, 1983; Barney, 1986; Barley et al., 1988; O’Reilly, 1989; Saffold, 1988). In a recent survey, Sackmann (2011) identifies 55 papers published since 2000 that study culture and performance. Most of these papers find support for both a direct and indirect link between corporate culture and company

21 Reciprocal causation (see Bandura and his social learning theory, 1986) means that these factors may influence each other reciprocally.

performance. This indirect link means that there is reciprocity²¹ between culture, leadership and organisational performance.

Corporate culture is linked to a company's reputation (Alsop, 2004; Carter and Dukerich, 1998). Cultural values, such as credibility, reliability, trustworthiness and responsibility, are at the core of such a reputation (Fombrun, 1996). Reputation itself can provide a sustainable competitive advantage over other firms and may affect financial performance (Jones, Jones and Little, 2000; Roberts and Dowling, 2002). Furthermore, a strong ethical culture, alongside a strong risk culture, should make banks and insurance companies less vulnerable to misconduct. A survey of 500,000 employees in over 85 countries found that across a wide range of companies (i.e. broader than banks) those with strong ethical cultures experience less misconduct. Indeed, employees in work cultures displaying high levels of integrity appear to have a 67% lower chance of observing business misconduct (e.g. accounting irregularities, insider trading) than those with cultures displaying low levels of integrity. In these types of firms, effective preventive measures help to ensure open communication between employees and managers, and to build trust in leadership (ESRB, 2014).

In summary, from the research on culture and performance we conclude that it is widely acknowledged that there is a relationship or influence of culture on organisational performance. Behavioural patterns within an organisation – where culture reveals itself in behaviour that can be observed – influence the organisation's performance. The large body of research from the field of organisational psychology on leadership, decision-making, communication and group dynamics as well as the effects on group or organisational performance, forms the foundation of DNB's supervision of behaviour and culture. The research and the effects on performance will be referred to in each Chapter. This psychological perspective on behaviour and culture within organisations is the perspective DNB has chosen, and which is reflected in this book.

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3

Model and Basic Assumptions

3.1 Introduction

'Weak and ineffective governance of systemically important financial institutions has been widely cited as an important contributory factor in the massive failure of financial sector decision making that led to the global financial crisis' (Group of Thirty, 2012, p.5). And 'Most studies of governance agree that it is behaviors, much more than frameworks and structures, that matter' (Group of Thirty, 2012, p.13). Other international reports also refer to behaviour and culture as a risk-driving force in financial institutions (FSA, 2009; Salz Review, 2013). Yet the existing economic paradigm that emphasises rationality, several cases of serious misconduct in the post-crisis years and our own inspections (DNB, 2013) lead us to conclude that the impact of behaviour and culture risks in financial institutions is underestimated and can even be regarded as a blind spot.¹ Edgar Schein, a prominent thinker and the most quoted scholar on organisational culture, is quite clear that this blind spot is actually quite common in organisations: 'Managers need to learn that where culture may matter most is in its impact on the "hard" stuff, such as strategy and structure. Most managers are quite blind to the fact that their strategies and structures are dominated by cultural assumptions and that histories of success and failure hardwire these cultural assumptions into their thinking' (Schein, 2000, p.xxiii).

¹ This 'psychological blind spot' can be compared to the blind spot of the eye: the part of our retina at the back where the optic nerve leaves the eye. There we see nothing but our brain automatically fills in the missing part.

Blind spots are human and part of life and have nothing to do with denial or unwillingness. Yet, they are persistent problems and can be risky: usually things are so obvious to us that we do not see their potential negative impact. In a nutshell, the supervision of behaviour and culture is intended to reveal blind spots and contribute to a greater understanding and awareness of behaviour and culture in the financial sector. The ultimate supervisory goal is to ensure strong and sound financial institutions that meet their obligations and thus to safeguard financial stability. Moreover, operational integrity and effective risk management are essential, and institutions must be led by effective boards (see Chapter 2).

In order to effectively and consistently identify (analyse) and mitigate (intervene in) behaviour and culture risks, it is crucial to develop a common conceptual model and a common supervisory language on behaviour and culture. By defining culture – both its visible and invisible aspects – in a concrete manner, we can apply this concept to supervision. The supervisory model on behaviour and culture directs the supervisory focus on relevant (potential) risks. A consistent interpretation of behaviour and culture risks is necessary to establish reliability and validity in the supervisory approach.

Chapter overview

This chapter aims to explain the model and basic assumptions underlying DNB's supervision of organisational behaviour and culture. Section 3.2 addresses the definition of culture. Section 3.3 explains DNB's supervisory model of behaviour and culture – the iceberg. Section 3.4 covers the risk-based focus in our supervision of behaviour and culture based on the iceberg. Finally, section 3.5 addresses the basic assumptions underlying the supervision of behaviour and culture.

3.2 Definition of culture

Organisational culture is commonly defined as the complex set of values, beliefs, philosophies and symbols that characterise the way in which a firm conducts its business (Sorensen, 2002).² It embodies the deep structure of organisations, which is rooted in the values, beliefs and assumptions held by organisational members. Culture is typically learned by members when they cope with external and internal problems and taught to new members as the correct way to perceive, think and feel. Schein (1984, 1985) describes organisational culture as responses that members of an organisation have learned in order to solve problems. His well-known definition is:

'A pattern of shared basic assumptions that the group learned as it solved its problems of external adaptation and internal integration, and that have worked well enough to be considered valid and, therefore, to be taught to new members as the correct way you perceive, think, and feel in relation to those problems' (Schein, 1984, p.1). These members' assumptions and beliefs define how the organisation is viewed by those members and by the outside world. Thus, they define the organisational purpose and provide members with behavioural norms. For employees, organisational culture is the social glue that holds the organisation together by providing appropriate standards for the ways employees should behave (Robbins, 1996, p.687). As a consequence, culture reduces employees' uncertainty and anxiety about appropriate and expected behaviour.

Schein has been especially influential because he articulated a conceptual framework for analysing and intervening in the culture of organisations (Hatch, 1993). According to Schein, culture exists simultaneously on three levels: on the surface are artefacts, under which are values and at the core are basic assumptions. Artefacts are the visible, tangible, and audible results

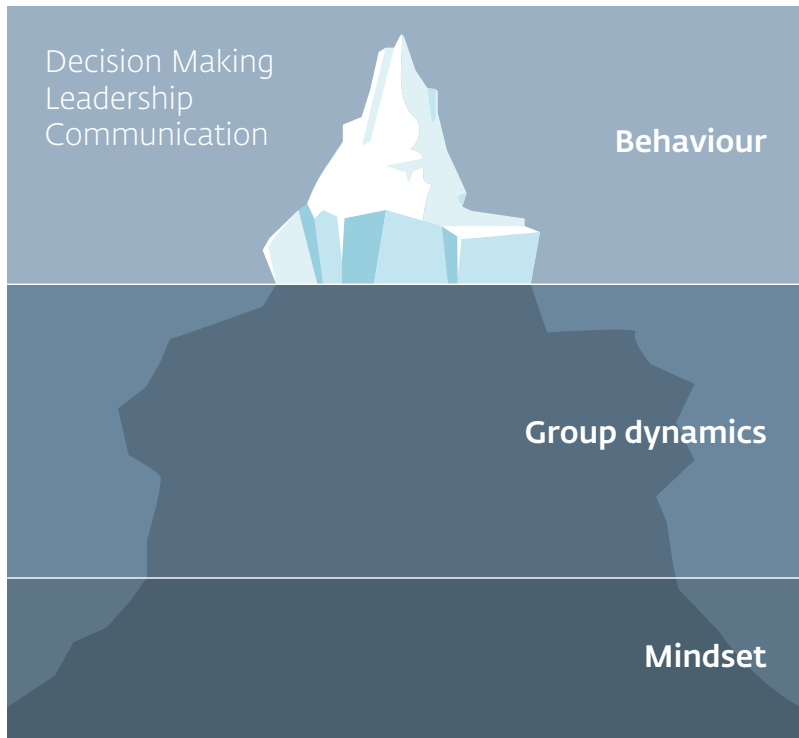
² Other definitions are: 'the specific collection of values and norms that are shared by people and groups in an organisation and that control the way they interact with each other and with stakeholders outside the organisation.' (Hill & Jones, 2001). Deal and Kennedy (1982) define organisational culture as 'the way things get done around here.'

of activity grounded in values and assumptions, for example, the company logo or clothing style. Values are social principles, philosophies, goals and standards which are considered to have intrinsic worth. Examples are customer focus, wanting to be the best, quality and transparency. The basic assumptions are beliefs about reality and human nature that are taken for granted. These beliefs are about how members of the organisation perceive the world (including customers, themselves, their work, internal relations). Is this perception one of optimism and trust or cynicism and distrust? Many of these basic assumptions are unconscious. DNB's model on behaviour and culture is strongly based on Schein's conceptual framework, which will be explained in the next section.

3.3 DNB's model on behaviour and culture: the iceberg

We distinguish three layers (Schein, 1990; Straathof, 2009) in organisational culture, i.e. 1) behaviour; 2) group dynamics; and 3) mindset. We use the metaphor of an iceberg to visualise our model, because the top (behaviour) is more easily directly observable while most of the iceberg is beneath the water and only indirectly observable (group dynamics and mindset).

Figure 3.1 DNB's supervisory model on behaviour and culture



The most visible manifestation of culture is **behaviour** (Cameron & Quinn, 2005; Schein, 1990; Straathof, 2009). In DNB's model, behaviour is everything people do that can be perceived by others (Huczynski & Buchanan, 2001; Sarafino, 1996; Tiggelaar, 2010). Behaviour is what you perceive; what you see and hear. What you can observe and what is expressed – verbally, in writing or non-verbal. For example, behaviour is someone running down the street or someone shouting or crying. These behaviours should not be mistaken for interpretations of these behaviours, such as someone is heading for the subway (running down the street), someone is angry or excited (shouting) or happy or sad (crying).

The scientific literature refers to two distinctions concerning behaviour that are relevant to the supervision of behaviour and culture. The first relevant distinction is between observable or overt behaviours, such as verbal activity, and non-visible or covert behaviours, such as thinking and feeling (see Drenth et al, 1997; Sarafino, 1996; Tiggelaar, 2010). In DNB's model, behaviour is defined as overt behaviour because this overt behaviour is tangible in the workplace, and what people say and do leads to tangible results for organisations. The second distinction is between individual behaviour, group behaviour and organisational behaviour (Cummings & Worley, 2009; Kreitner et al., 2002; Robbins, 2002; Rollinson & Broadfield, 2002; Tiggelaar, 2010). DNB's supervisory model on behaviour and culture focuses primarily on group behaviour and the interaction between certain individual roles – such as the CEO – and the group. The supervision of behaviour and culture does not focus on the individual competences of board members, as is the case in fit and proper testing. Chapter 6 on leadership will elaborate more on this distinction with fit and proper testing.

DNB pays special attention to behaviours related to decision-making, leadership and communication, because these behaviours are considered important for groups that work together and depend on each other to achieve goals and results (Forsyth, 1999). International standards and

guidelines also refer to the importance of such behaviours.³ Decision-making, leadership and communication are therefore important ingredients for the sound execution of the management body's responsibilities. And sound execution of responsibilities is the basis for the sound and prudent management of institutions.⁴ In financial institutions, decision-making revolves around the question of how key figures make decisions and choices.

One example is decisions concerning a merger or strategic investment. Are these decisions based primarily on the costs and benefits associated with the merger or investment? Is an investment mainly a matter of estimated (short-term) costs and (long-term) benefits? And if so, what are the board's goals? To what extent and in what way are the members' own interests involved? What role do the interests of others play? How are these different interests weighed? Is this done in a rational manner, where all the advantages and disadvantages are considered? What role do emotions play in these choices?

The corresponding chapters in this book will elaborate more extensively on the key elements of Decision-Making, Leadership and Communication.⁵

3 On the subject of decision-making, see, for example, EBA Guidelines Title II. B. Management Body, paragraph 12: 'Members of the management body shall engage actively in the business of an institution and shall be able to make their own sound, objective and independent decisions and judgements.' As regards leadership, see, for example, EBA Guidelines, Title II. B. Management Body, paragraph 8: 'the management body shall have the overall responsibility for the institution and shall set the institution's strategy', and on the subject of communication, see EBA Guidelines, Title II. B. Management Body, paragraph 8: 'The key responsibilities of the management body should include setting and overseeing a robust and transparent organisational structure with effective communication and reporting channels'.

4 See e.g. Article 74 of the Capital Requirements Directive IV (internal governance and recovery and resolution plans) and the EBA Guidelines on Internal Governance, explanatory note to par. 8.1 (responsibilities of the management body).

5 By adopting this focus, DNB has chosen to look two levels deeper than it had previously done. In the past, DNB had focused primarily on visible behaviour, as explained in its policy vision on 'The 7 elements of ethical culture'. The seven elements still serve as key elements of Decision-Making, Leadership and Communication in the current model.

Group dynamics is defined as the interaction between different positions and patterns within a group or between groups, which affect overall group effectiveness. Is there an atmosphere where people can address unwanted or 'bad' behaviour? Is there an atmosphere of cooperation or competition, perhaps infighting? Is there a basis of mutual trust within a board, between the board and the board of directors and/or the senior management? Or does distrust predominate in the working relationships?

During one of our inspections we attended a (one-tier) board meeting and observed the following dynamics in the group. The CEO and CFO whispered to each other several times when the chairman was speaking. The CEO's chair was an arm's length from the table, he sat with his arms folded across his chest, squinted his eyes and extensively perused his papers. Another board member was staring at the ceiling and looked out the window on numerous occasions. It gave us the impression that there were interpersonal tensions, board members seemed to feel obligated to be there and there appeared to be a lack of trust. Moreover, after the meeting, all members of the board admitted there was an atmosphere of distrust.

Influence and a positive or negative perception of the group play an important role in almost every group. As a result, peer pressure makes individuals behave as group members and impacts behaviour. In essence, peer pressure regulates behaviour. A well-known aspect of peer pressure which is relevant to supervision is the influence of people with a high position in the hierarchy of a group. The far-reaching impact of group dynamics is shown in one of the most famous psychological experiments, The Milgram Studies.⁶ The explanation for the impact of group dynamics on behaviour is that every human being wants to be part of a group or has a need for 'affiliation' (Maslow, 1973). Belonging to the group meets basic

psychological needs such as (psychological) safety, self-affirmation and uncertainty reduction.

The deepest level of organisational culture is **mindset**: these are deeply held beliefs and values (Schein, 1990) that often guide group dynamics and individual behaviour. People have a lot of images and assumptions about reality and the functioning of that reality: these are also referred to as 'mental models' of this reality (Senge, 1998). Most of these mental models (or basic assumptions) are implicitly or unconsciously present. Basic assumptions influence behaviour because they filter what people perceive, they indicate how employees ought to interpret experiences and influence judgement in terms of right and wrong. Certain attitudes and beliefs gain the status of truth (Straathof, 2009). Basic assumptions about reality and shared values are fundamental to every organisation (Boonstra, 2010).

An individual's mindset determines how the world works in his or her eyes, who to trust and who not to trust, and what has priority. For example, on a trading floor, a mindset of wanting excitement, quick results and an adrenaline rush is much more common than the risk-averse mindset seen in most internal audit departments.

6 Stanley Milgram (1963) was interested in researching how far people would go in obeying an instruction if it involved harming another person. The participants were 40 males, all of whom were assigned the role of 'teacher'. Two rooms in the Yale Interaction Laboratory were used – one for the learner (with an electric chair) and another for the teacher with an electric shock generator. The 'learner' (who was part of Milgram's staff) was strapped to a chair with electrodes. After the learner memorised a list of word pairs, the teacher had to test the learner's recall of the words. The teacher was told to administer an electric shock every time the learner made a mistake, increasing the level of shock each time. There were 30 switches on the shock generator, marked from 15 volts (slight shock) to 450 (danger – severe shock). The learner gave mainly wrong answers (on purpose) and for each of these the teacher gave him an electric shock. When the teacher refused to administer a shock, the experimenter gave a series of orders to ensure they continued. 65% (two-thirds) of participants (i.e. teachers) continued to the highest level of 450 volts. All the participants continued to 300 volts. Milgram concluded that ordinary people are likely to follow orders given by an authority figure, even to the extent of killing an innocent human being. Obedience to authority is ingrained in us all from the way we are brought up.

3.4 Risk focus based on the iceberg

In order to impact and change risky behaviour and culture in organisations, we need a deep understanding of what drives risky⁷ behaviour. A detailed understanding of the different layers is necessary in order to understand organisational culture and to be able to target changes (Schein, 2000). This in-depth insight is the basis for effective risk mitigation.

We focus on behaviour and culture risks that (potentially) impair the performance of financial institutions and increase the risk profile of an institution. This would include boards that take strategic decisions in an impulsive or opportunistic manner concerning a merger or an investment, or a board that appears dominated by one or two board members. Or indeed financial institutions that have initiated large-scale changes, but are unable to implement them successfully.

In line with our iceberg model we identify risks related to decision-making, leadership, communication and group dynamics.⁸ The key question for DNB is whether these behaviours and group dynamics are systematic (behavioural patterns) or coincidental. Behavioural patterns are behaviours that are usually unconscious and automatic, and occur on a regular basis. Individuals and groups develop behavioural repertoires or behavioural solutions for all kinds of situations. Behaviour does not occur by chance, but because it has significance (Straathof, 2009). This significance usually evolves when certain behaviours are an effective solution to a problem or for achieving a goal (Schein, 1992). Solutions that are more frequently used lead to patterns of behaviour (Willcoxson & Millett, 2000; Straathof, 2009). These are ingrained habits that individuals and groups do not recognise themselves because they seem so natural. Furthermore, these behavioural

⁷ This focus on risk in behaviour and culture is consistent with DNB's risk-oriented supervision approach, which is based on Malcolm Sparrow's philosophy and is explained in Chapter 4.

⁸ In the chapters on decision-making, leadership, communication and group dynamics we will specify what types of behaviour, group dynamics and mindset we are concerned with and how we identify and assess them.

patterns can impede group performance (as is the case in the example) and are therefore relevant to supervision.

The next step involves mitigating the identified and assessed risks, which implies changing risky or unsound behaviour and behavioural patterns. We are convinced that people can change their behaviours and behavioural patterns. In our approach, the primary lever to realise those changes is by tapping into individuals' 'autonomous motivation'. Autonomous motivation or 'doing something because you want to' is usually driven by a high level of personal acceptance of goals and a high level of personal freedom (or autonomy). The opposite of autonomous motivation is controlled motivation or 'doing something because you must'. This stems from the Self Determination Theory (Ryan & Deci, 2000). Chapter 4 will elaborate more extensively on how we implement these concepts in our risk mitigation strategy.

3.5 Basic assumptions of supervision of behaviour and culture

In addition to a clearly defined model, DNB's supervision of behaviour and culture is based on five basic assumptions that are at the root of the supervision of behaviour and culture. This section explains these assumptions and presents the empirical evidence that underpins them.

The five assumptions are:

- Behaviour and culture are ultimately the responsibility of financial institutions.
- Supervisors can identify, assess and mitigate risks concerning behaviour and culture in financial institutions.
- Behaviour and culture are an integral part of the bigger organisational picture and should therefore be supervised in line with the strategy and business model, strategic organisational business goals and governance.

- Behaviour and culture supervision is most effective when supervisors adopt a tailored focus in setting their expectations of financial institutions instead of 'blueprinting' the right organisational culture.
- Boards of financial institutions and their top leaders are the main focus of supervision of behaviour and culture.

Behaviour and culture are ultimately the responsibility of financial institutions

While we think that supervisors have an obligation to focus on behaviour and culture, ultimately behaviour and culture are the responsibility of financial institutions and their boards. The Banking Standards Review (2014) states: 'The overriding responsibility for improving the behaviour of banks must lie with the leadership of the institutions themselves, operating within the framework set out by the regulators. It is for them to define the values and purpose of the banks which they lead, to appoint and promote people who are aligned with its values, to decide which types of business they are happy to accept and which to turn away, and to do everything in their power to make sure that the tone set at the top reaches all the way down through these often very large organisations.' Supervisors also have an obligation and a legal mandate to identify risks concerning behaviour and culture, and we expect financial institutions to mitigate these risks (see also Chapter 2). Supervisors are responsible for setting the agenda in terms of a substantial focus on behavioural and cultural risks and encouraging financial institutions to identify and mitigate those risks. In this manner, supervision raises the bar for behaviour and culture in the financial sector, which contributes to ensure a sound and solid financial sector.

However, this does not mean that DNB takes ownership or sits on the drivers' seat, nor that it takes on a coaching or advisory role in specific interventions to change behaviour. For example, DNB does not own the risk of organisations having a dominant leader; this lies with the

organisation's executive and non-executive board. But it is our obligation to identify whether the leadership (dominant, authoritarian) and group dynamics (a passive group of followers who are not able to challenge and dissent) of an organisation may lead to risks, such as unbalanced decision-making through a lack of challenge. Whenever such risks are identified, we make them explicit, challenge the board and expect it to take mitigating action. Financial institutions are required to follow up on our expectations, subject to appropriate laws and regulations. We then monitor closely whether the risks are mitigated effectively.

Behaviour and culture in financial institutions can change

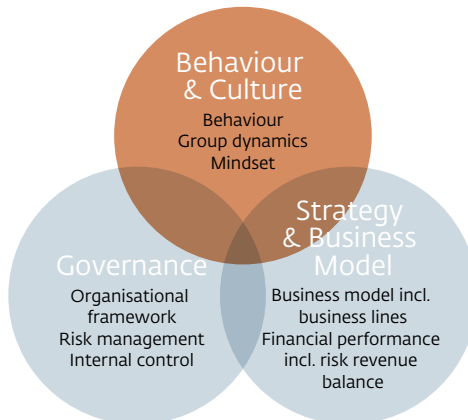
DNB is convinced that behaviour and culture in the financial sector can be changed. This conviction is predominantly rooted in a scholarly tradition based on empirical data that behaviour and culture changes can be realised in an organisational context (Azjen & Fishbein, 1977, 2005; Kotter & Haskett, 1992; O'Reilly & Tushman, 1997; Schein, 2000). A breakthrough for this kind of thinking came with the famous book *In search of excellence* by Tom Peters and Robert Waterman (1982) that sees culture as an aspect of the organisation, just like strategy, structure, HR and IT, which can be managed and intervened upon. An aspect that can be measured, manipulated and changed just as organisational variables such as skills, strategy, structure, systems, style and staff.

This scholarly tradition states that organisational cultures can develop and change through consciously changing the core of culture. This is achieved by formulating new common images or shared beliefs that can constitute a new culture. These new beliefs are expected to develop into new values and new behavioural solutions and, in turn, support and reaffirm the new basic assumptions (Schein, 1990; Straathof, 2009). Leadership plays a central role in realising these changes. DNB holds the position that these changes are complex and do not come overnight, yet, they are possible.

An integral and contextual approach to behaviour and culture

DNB is convinced that the culture of an organisation does not develop in a vacuum but is the product of a combination of external as well as internal processes and factors (Bate, 1994; Wilber, 1996). Scholars widely agree that an organisation responds to and reflects industry characteristics such as the competitive environment and customer requirements, but also the values of its employees and the values and behaviours of its founders or early leaders (including Gordon, 1991; Ott, 1989; Schein, 1985). In the supervision of behaviour and culture, the focus is primarily on the interaction of organisational culture with the internal organisation (structure, governance, business and systems) and less on the external organisational context (customers, macroeconomic developments, financial markets)⁹ (see Figure 3.2).

Figure 3.2 The integrative perspective on behaviour and culture, governance and strategy & business model



⁹ The latter is usually part of the assessment of on-going or account supervision.

More specifically, the strategy, structure, processes and culture of an organisation are formed by a central purpose and complement each other (Miller, 1996). Since behaviour and culture are influenced by multiple factors, a multisided or integral view is needed. In the supervision of behaviour and culture, risks are identified, assessed and mitigated in relation to strategy, governance and business operations.

A financial institution has launched a new strategy for its service centre, involving a behavioural change. Service centre employees are now expected to provide direct customer support and deal with customer complaints themselves.

In the past, the institution never dealt directly with its customers, but worked with intermediaries selling products and maintaining customer contact on behalf of the institution. In dealing with the intermediaries, the service center employees used to work with detailed prescriptive protocols and extensive checklists.

In the new strategy, it is the service centre employees who are responsible for customer contact, which means they now have to use their problem-solving skills rather than protocols and checklists.

This example involves a huge change for the service centre employees and their managers, having to switch from using checklists as their main tool of communication to drawing on their conversational and problem-solving skills. The extensive use of and excessive dependence on checklists to direct behaviour and solve problems is an example of an ingrained behavioural pattern that can threaten a successful implementation of the new strategy. The reality of this threat is part of supervisors' perspective in every behaviour and culture examination.

Adopt a tailored focus

The supervision of behaviour and culture focuses on related risks that can (potentially) adversely affect the performance of financial institutions and jeopardise the soundness and integrity of the institution. In weighing these risks, we apply our findings to the specific context of the financial institution without using this situation as an excuse for unwanted behaviour or culture. This context-dependent approach makes the supervision of behaviour and culture complex, but not impossible. We handle this complexity by clarifying and explaining what we expect in terms of behaviour and what we consider to be ineffective and undesirable.

More specifically, we focus on the minimum requirements needed to prevent or mitigate behavioural and cultural risks in terms of decision-making, leadership, communication and group dynamics. There are certain behaviours that are ineffective, regardless of the context. For instance, groupthink is considered a risk for every board, in every context and any situation. But we are not focused on pushing institutions towards an optimum, which we consider the primary responsibility of the institutions themselves.

In stating the minimum requirements, we do not focus on blueprinting organisational culture in terms of what DNB considers desirable. Our supervision is not based on a precisely defined, desired culture for all financial institutions – a 'one-size-fits-all approach', as each organisation has its own patterns and habits, its own culture. This tailored approach to culture stems from the Contingency Theory (Gailbrath, 1977; Scott, 1977), which is often applied to the effectiveness of organisations and asserts that there is no 'one best way' (or blueprint) to organise, lead a company, or to make decisions.

The supervision of behaviour and culture focusses on risks concerning key behaviours (decision-making, leadership and communication) and does

not pretend to capture the culture of an organisation. Behavioural risks may lead to business risks. We believe that pigeonholing the complexity, dynamics and diversity of financial organisations into one image of culture is unrealistic and impossible. In addition, blueprinting the desirable culture creates the illusion that identifying and changing organisational culture is easy to fix and simply a matter of 'pressing the right buttons'. This pitfall was recently addressed (Paradigm Risk Consulting, 2014) in response to the Financial Stability Board's paper on risk culture (2014).

Furthermore, we think it is a matter of principle that a supervisor should not blueprint the desired organisational culture – even though financial institutions often ask us to do this. The rationale behind this position is that framing the desired culture is a key responsibility of the institutions themselves. An organisation is best known and understood by its employees, managers and board. Asking a supervisory body to prescribe the desired culture is asking it to 'sit in the driver's seat' and that is something supervisors generally avoid. So, boards and leaders have an important role. The last assumption focusses on the role and impact of leaders.

Boards of financial institutions and their top leaders are the main focus of the supervision of behaviour and culture

There are two reasons for the assumption that formal and informal leaders function as a primary 'lever' for the supervision of behaviour and culture. First, because of the impact of the board on performance. Second, because of the impact of leaders on organisational change.

Clearly, boards and leaders impact performance. Hambrick and Mayes (1984) have been influential in this field and set the tone when they shifted the focus from techno-economic and process factors to 'the dominant coalition in organisations' (Hambrick & Mayes, 1984, p. 193). Furthermore, they argue that strategic choices have a large behavioural component and to some extent reflect managers' demographic characteristics (such as values, age, education, socioeconomic background), influence

the decisions that they make and therefore the actions adopted by the organisations that they lead. They suggest that this occurs because demographic characteristics are associated with the many cognitive bases, values, and perceptions that influence managers' decision-making. Since this publication, the upper echelons theory was developed (Carpenter et al. 2004; Finkelstein et al. 2009; Nielsen, 2010) and several studies have supported the relationship between upper echelon characteristics and organisational strategies and performance. For example, there is evidence that top management team (TMT) job-related diversity is related to the internationalisation of firms (Lee & Park, 2006). TMT diversity in age, tenure and education has also been associated with organisational innovation (Camelo-Ordaz et al, 2005; Bantel & Jackson, 1989), changes in corporate strategy (Wiersema & Bantel, 1992), and information use (Dahlin et al, 2005). And finally, TMT gender diversity interacts with organisational culture and growth orientation in affecting organisational performance (Dwyer, Richard & Chadwick, 2003).¹⁰

A second rationale for the assumption on the influence of boards and leaders stems from the literature, which emphasises the shaping role of leaders in creating, maintaining or transforming culture (Willcoxson & Millett, 2000). Essential to the development of organisational culture is the predominance of certain concepts, values and solutions, in combination with people who bring these forward (Senge, 1998). We assume that the relationship between leadership and culture is reciprocal. Culture can also shape the members of the organisation, including the leadership (Parry & Proctor-Thompson, 2003). Certain attitudes and beliefs are given the status of truth and certain behavioural solutions are seen as more or less successful. When certain opinions and solutions become prominent to the collective, the people who put forward these opinions and solutions usually acquire a dominant role in the group (Straathof, 2009).

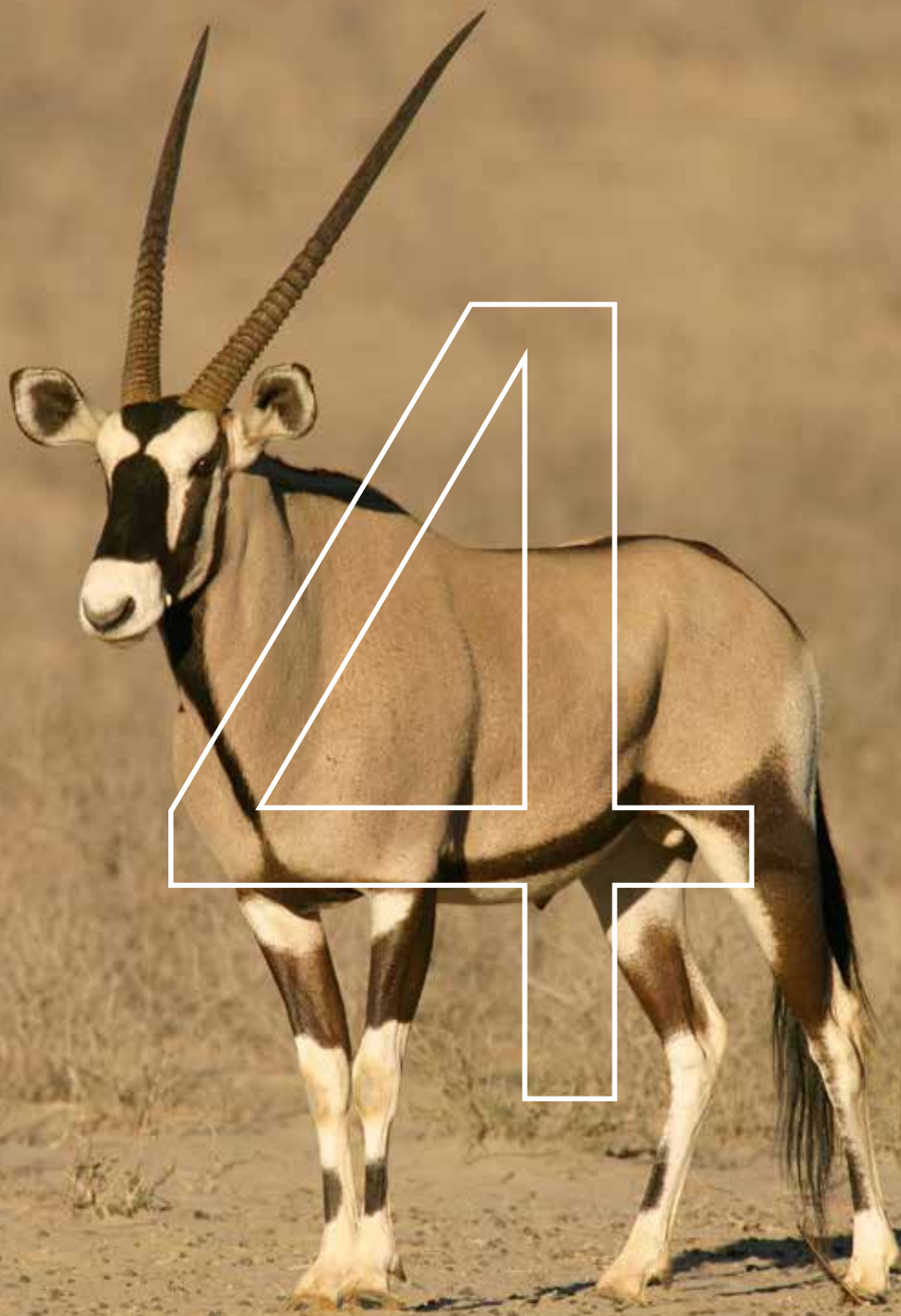
¹⁰ We want to add that we are fully aware that the extensive literature and research on diversity in organisations shows that diversity is not only related to positive outcomes, but also to negative organisational outcomes (Adams et al, 2015; Raaijmakers, 2008).

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Supervisory Approach and Methodology

4.1 Introduction

This chapter will explain how the supervision of behaviour and culture is carried out: the approach and tools as well as specific issues supervisors face when executing this type of supervision. Like any supervisory process, the core of behaviour and culture supervision is to collect data and identify the related risks, assess these risks and then decide how they can be mitigated by the financial institution. After all, the ultimate supervisory goal is to influence behaviour and culture, and not (just) the risk diagnosis. In order to do this, an adequate framework and risk indicators are needed to guide the supervisory process of risk identification and assessment. This also includes a benchmark in terms of good or bad, desirable or undesirable, high or low risk practices.

Chapter overview

This chapter starts with explaining DNB's risk-based supervision cycle that includes behaviour and culture as a risk driver (4.2). Section 4.3 addresses the core elements of this type of supervision. Section 4.4 gives an overview of the steps in our on-site inspection strategy. The subsequent sections cover these more thoroughly, whereby 4.5 elaborates on context analysis; 4.6 addresses risk identification; 4.7 goes into risk assessment and finally 4.8 explains in depth the behaviour and culture strategy of our supervision aimed at effective risk mitigation.

4.2 DNB's risk-based supervisory cycle

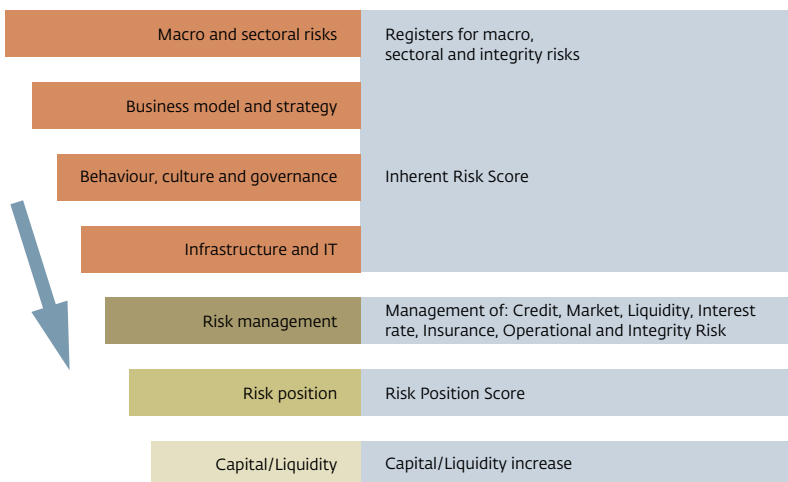
Behaviour and culture as a risk driver

DNB's risk-based supervisory cycle – analysis, judgement and mitigation of risks – is based on insights derived from different angles. It draws on macroeconomic and sectoral developments, as well as specific themes, and uses these as a basis for zooming in on individual risks. This process includes an explicit assessment of the business model and strategy as well as the behaviour and culture of supervised institutions. More specifically, DNB considers behaviour and culture to be a risk driver, which means that a financial institution's behaviour and culture are considered underlying factors (among others) that lead to the manifestation of risks. Collectively, the risk drivers determine the degree of vulnerability (or stability) of the institution or group of institutions. This focus on risk drivers encourages supervision to focus more closely on potential sources of later problems (DNB, 2012).

In DNB's risk-based supervisory approach, a behaviour and culture inspection is preceded by a risk-based selection by DNB among financial institutions. There are mainly two ways that supervision becomes aware of behaviour and culture risks: 1) top-down or sector-wide analysis and 2) bottom-up or institution-specific analysis. The top-down approach means that risks concerning behaviour and culture emerge through a risk-driver assessment (see Figure 4.1). A thorough analysis of risk drivers makes clear which individual risk groups have the greatest impact, insofar as the consequences can be foreseen without an in-depth analysis of the risks themselves (DNB, 2012). For example, substantial changes in the board or the senior management, incidents concerning unsound behaviour of key figures or non-compliant behaviour.

In its analysis, supervision also includes bottom-up indications of specific problems – reported in the workplace or elsewhere. For example, a midsize financial institution with a history of compliance and integrity issues,

Figure 4.1 Top down risk-analysis based on four risk drivers



and facing a financially challenging situation, required a disproportionate rate of ongoing supervisory attention. As part of this ongoing supervision, a request was made for behaviour and culture expertise because several interventions, both structural (including an explicit positioning of risk management in the organisation) and formal (such as a fine for integrity violations) did not seem to have significant impact. Ongoing supervision wanted to get to the root cause of this protracted, non-compliant and destructive behaviour and said: 'there's something about the way these people behave that we can't figure out or grasp.' These types of bottom-up signals usually result in a behaviour and culture supervisory examination.

Usually a pattern evolves in such top-down and/or bottom-up signals. For example, during our examinations of decision-making and board effectiveness, it was clear that financial institutions face a major change agenda. They are also under a lot of pressure – from different stakeholders such as consumers, politics, society and shareholders – to change

Table 4.1 Overview of typical behaviour and culture inspection types

Inspection types	Inspection approach	Inspection objective
Board effectiveness	On-site approach to determine if, and to what extent, behaviour and group dynamics at board level impact prudential and risk performance	Insight into risks related to a board's decision-making, leadership, communication and group dynamics which impair effective board performance and sound and principled business operations
Change effectiveness	On-site approach at organisational level to determine if banks are able to successfully implement organisational and cultural change programmes	Insight into the capacity of financial institutions to change. More specifically, we focus on strengths and weaknesses in terms of translating the vision, willingness to change, implementation and ability to learn
Risk culture	On-site approach to assess behavioural patterns that have a (potentially) detrimental impact on decisions on risk awareness, risk taking and risk management	Identify, assess and mitigate behavioural patterns that have a (potentially) detrimental impact on decisions on risk awareness, risk taking and risk management
Root cause analysis	Off-site research aimed at identifying (underlying) causes for risks at behavioural, group dynamic and mindset level	Find behaviour and culture explanations for issues that involve difficult and persistent problems at financial institutions. Develop an effective mitigation strategy that intervenes in the drivers of the unsound and ineffective behavioural patterns

fundamentally and effectively. This eventually led to several thematic inspections concerning the capacity for change. The next section gives an overview of the scope of the supervision of behaviour and culture.

Behaviour and culture scope

Over the past five years, the scope of the supervision of behaviour and culture has been expanded to include four inspection types (see Table 4.1 for an overview). The majority of past inspections were focused on board effectiveness, with a specific focus on sound decision-making, leadership, communication and group dynamics.

Regarding inspections of board effectiveness, risk culture and root cause analysis, the focus is on key behaviours and behavioural patterns of a particular group – such as the Board of Directors, the Supervisory Board or the senior management – or a particular part of a financial institution – such as the risk and finance pillar, the trading desk, financial markets division, or compliance. In these three inspection types, supervisors drill down through the three layers of the iceberg of behaviour and culture. The inspections of capacity for change take a different approach, focus and set of tools.

4.3 Core elements of supervision of behaviour and culture

The central role of perception

DNB's iceberg model – including the mindset, group dynamics and behaviour layers – can be compared to what Schneider (2000) refers to as the psychological life of organisations. An important ingredient in organisations' psychological life is perception.¹ Moreover, behaviour

¹ In the organisational literature, research focused on perception in the workplace is sometimes referred to as 'organisational climate'. For the sake of clarity and consistency, we use the term organisational culture.

involves everything people do that can be perceived by others (see, for example, Huczynski & Buchanan, 2001; Sarafino, 1996; Tiggelaar, 2010;). So the role of perception is key in this type of supervision. After all, behaviour and culture are predominantly social constructs that are 'made' by human beings thanks to their ability interpret and construct reality (Patton, 2002). This does not mean that social constructs such as culture are fictitious. Consider the famous quote by Thomas & Thomas (1928, p. 571): 'if men define situations as real, they are real in their consequences'. In other words, the interpretation of a situation causes the subsequent action. This interpretation is not objective and actions are affected by subjective perceptions of situations. Whether there actually is an objectively correct interpretation is not important for the purposes of understanding and impacting behaviour. Perceptions evoke and direct behaviours. Therefore, they are a primary source of information for the supervision of behaviour and culture.

This emphasis on perception sometimes evokes the reaction that inspections of behaviour and culture are not evidence-based and are subjective. Yet, in behavioural sciences it is very common to base findings on perceptions. According to Schein (2000), there are two primary approaches to studying organisational culture. Both are valid methodologies. One is to build typologies of cultural 'states': categories that freeze a given organisation at a given point in time. Yet, as we stated in Chapter 3, we avoid 'blueprinting' or freezing the culture of an organisation. The second approach is to analyse the moment-to-moment interactions in which members of a given social system attempt to make sense of their experience and, in that process, reinforce and develop culture. Our risk identification methodology is based on analysing interactions, not freezing the organisational culture. In other words, supervision 'based on perception' means supervision based on a professional analysis of this sense-making and interactions. As a consequence, supervisors need, in order to reach a sound, data/evidence-based professional judgment, valid methods

and tools that grasp this type of data. The section on risk identification (4.6) gives an extensive overview of the different methods we use.

The issue of trust

A specific issue that arises during the inspections of behaviour and culture is the nature of the relationship between the supervisors and the financial institution. Our inspections require a reasonable degree of openness and willingness, or trust,² to share sensitive information that is sometimes perceived as 'up close and personal'. In addition, behavioural patterns and habits are, inevitably, mainly unconscious and are usually rarely discussed or even considered, which further emphasises the need for an environment that is psychologically safe enough to talk about these issues.

While DNB's supervision is mandatory and formally agreed upon by the institution, establishing a reasonable sense of openness does not come naturally. Two important factors need to be considered here: a) the level of trust that the financial institution already has in DNB, and b) the fact that this supervisory relation with DNB is mandatory or as one board member recently said: 'this is a charged relationship'. Research in the context of regulation shows that there is a strong reciprocity between the trust an organisation has in its regulator (institution-based trust) and the trust it has in employees that represent that regulatory institution (Nooteboom, 2002). This reciprocity also applies to our inspections, since we operate in the existing dynamic between the financial institution and DNB. More specifically, we start out at an 'entry level' of trust, which is generally based in part on earlier experience with supervision and determines the starting point of the amount of trust during our inspections.

² Trust is a complex human emotion that is formed through life experiences and, as a result, shapes individuals differently. It builds upon a broad continuum driven by competence, integrity, and confidence. Involving cognitive, emotional, and behavioral dimensions, trust is generally viewed as a positive attribute that allows one to have faith in mankind to do the right thing (Colquitt, Scott, & LePine, 2007). Trust is defined as an awareness of relational risk, i.e. the possible harm from dependence, with the belief that harm will not in fact be done (Nooteboom, 2002).

Knowing that this dynamic plays a role is important for a supervisor. Gaining access to information requires extra attention, because such access to the informal side of the organisation is limited due to the mandatory nature of this relationship. This means that we are usually not told what is really going on until insiders in the organisation feel comfortable that we can be trusted. As Schein (2000) states, in any form of organisational analysis – and thus also for supervisors digging into the deeper layers of the culture – this can only happen if the supervisor and the organisation form a mutually trusting and constructive relationship. Also, we proactively address this dynamic during the kick-off meeting we have with the management board, in which we acknowledge the tension between striving for reasonable openness in a relationship that is mandatory. It is our experience that financial institutions appreciate the fact that we do not beat around the bush about this.

We strive for a middle position between distrust and blind trust (see also Bos, 1997). Trust, though complex, is established through relationships (Pixton, 2008). Every interaction is an opportunity to build trust. The reactions we often get is that people are surprised that they share more information with us than they intended to do prior to the interview. Also, leaders tell us that the subjects we address and the way we address them are usually far more intrusive and confronting than they are used to. Moreover, they explain this by stating that people are reluctant to be frank and open towards them, because of their high status due to their position. Finally, institutions and their members often acknowledge the results of our assessment, which means we are able to uncover the essential issues within an institution.

In most cases, therefore, we are able to create the necessary openness and trust required to gather information. At the outset of every inspection, we invest time in holding a kick-off meeting with the management board to achieve a baseline of trust and openness. During this meeting, we are transparent about the assumptions and context analysis that drive

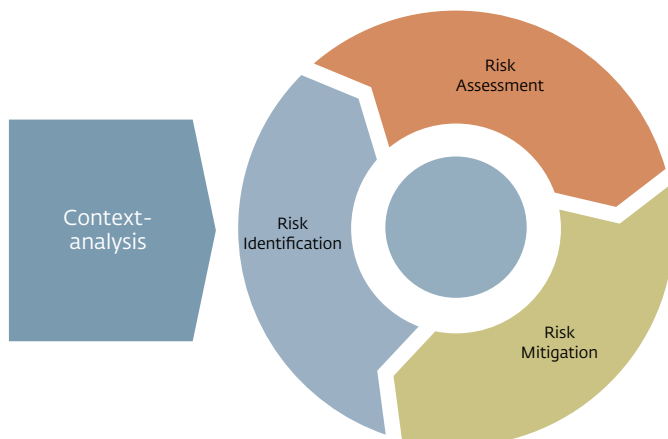
the inspection. We prefer to inform the organisation during a face-to-face meeting instead of sending a letter. We believe that building trust and addressing – usually healthy – suspicions can only be established through face-to-face contact. In sum, ensuring face-to-face contact, communicating expectations and information on the inspection and emphasising the reciprocity of the relationship enhances the effectiveness of the inspection.

4.4 The Supervision cycle for behaviour and culture

An on-site inspection of behaviour and culture consists of the following phases:

- 1) context analysis;
- 2) risk identification;
- 3) risk assessment and
- 4) risk mitigation (see Figure 4.2).

Figure 4.2 DNB's supervision cycle



The following sections will explore these phases in more detail, with a specific focus on topics we think should be addressed in a supervisory approach to behaviour and culture. Figure 4.3 provides an overview of the specific topics addressed in the following sections.

Figure 4.3 Topics addressed in the following sections

4.5 Context Analysis	4.6 Risk Identification	4.7 Risk Assessment	4.8 Risk Mitigation
<ul style="list-style-type: none"> ■ Purpose ■ Desk research ■ Inspection hypothesis ■ Select key decision ■ Kick-off meeting 	<ul style="list-style-type: none"> ■ Purpose ■ Multi-method approach ■ B&C instruments: <ul style="list-style-type: none"> - desk research - self-assessment - interviews - survey - observation 	<ul style="list-style-type: none"> ■ Purpose ■ 5 assessment steps: <ul style="list-style-type: none"> - individual perspective - group perspective - challenge - final assessment - final challenge ■ Risk categories 	<ul style="list-style-type: none"> ■ Challenge and change ineffective drivers ■ Challenging dialogue ■ Multiple and multilevel interventions ■ Perseverance

4.5 Context analysis

Purpose of this phase

The purpose of context analysis is a) to gain a deeper understanding of the context in which the particular financial institution functions and the financial institution itself and b) to establish focus for the supervisory inspection.

Core elements of this phase

The context analysis phase consists of four main activities:

- 1) desk research;
- 2) develop a central inspection hypothesis on behaviour and culture;
- 3) select a key decision;
- 4) kick-off meeting with CEO and management.

1. Desk research

To gain more insight into the context, it is important to examine the nature of the market the organisation is involved in, what kind of business model the financial institution has, the biggest problems and risks it faces, the key players involved and what drives their behaviour. In this phase we also analyse general aspects of the governance of the institution with the emphasis on obtaining objective information on operational structure (such as business lines) and the corporate (including) internal governance (such as organs, committees, composition, definitions of roles and responsibilities, (key)functions, and structures and processes), HR (codes of conduct, HR surveys on employee satisfaction, governance code succession planning, talent management, incentives, internal/external evaluations of control) and risk management. This part of context analysis is done in consultation with on-going supervision through desk research.

2. Inspection scope

We develop a central focus or question concerning decision-making, leadership, communication or group dynamics. For example, the supervision team for a large financial institution had trouble detecting whether the management board or the supervisory board was 'calling the shots'. After an analysis of the different dynamics at the top of the organisation,³ we decided to focus on the effectiveness of the supervisory board. This was because the supervisory board seemed to play a pivotal liaison role between the management board and two main shareholders of the institution. Other examples of inspection-focus involve, for instance, the behaviour and culture explanations for the lack of execution of a board, which arguments and stakes were involved in the decision-making process and how were they assessed concerning a strategic investment. We usually work intensively with ongoing supervision to gather as much information as we can on behaviour and culture. An additional aspect of the context

³ This analysis consists of an overview of the quantity and the quality of the professional relationships at the top of the organisation, for example the nature and the frequency of contact between the CEO and the chairman of the supervisory board.

analysis is the supervisory dynamics between ongoing supervision and the financial institution. Is this a constructive relationship or is there a lot of misunderstanding and, perhaps, a lack of trust?

In our inspections of capacity for change we use a different approach to realise optimal focus. Here, we formulate the central focus of the inspection in collaboration with the financial institution. The most important reason to do so is to create a buy-in, as will be explained in the chapter on this topic.

3. Select a key decision

We establish focus by choosing a strategic decision-making process to zoom in on underlying behavioural patterns. The term 'strategic choice' is used here in the same way as in Child (1972). Strategic choices stand in contrast to operational choices such as inventory decisions and credit policies, which lend themselves more to calculable solutions (see Hambrick & Mason, 1984). Consider, for instance, decisions that concern mergers and acquisitions, the introduction of new products or the design and implementation of behavioural changes in the organisation. Zooming in on a concrete decision makes it possible for the investigators to search beyond the top layer of the iceberg and tap into the underlying behavioural patterns, group dynamics and mindset that are usually harder to see. During the inspection, we examine whether and how individual and collective behavioural patterns are related to financial and not-financial risks that threaten the financial solidity and integrity of the organisation. This will be further elaborated on in the next section on risk assessment.

4. Kick-off meeting

As mentioned in the section on trust, there is a kick-off meeting with the management board to establish a baseline of trust and openness. During this meeting, the assumptions and context analysis that drive the investigation are discussed.

4.6 Behaviour and culture risk identification - what are our point of interest?

Purpose of this phase

In general, the purpose of the risk identification phase is to uncover which risks and signals are related to (possible) negative outcomes for the institution. In line with the iceberg model, we focus on risks related to key elements in decision-making, leadership, communication and group dynamics (see the subsequent chapters in this book for an elaboration of these key elements). In order to impact and change organisations' risky behaviour and culture, insight and a deep understanding of which behavioural patterns create risk are needed. These insights will give supervisors a starting point in effectively assessing and mitigating (preferably by means of an challenging dialogue) risky behavioural patterns.

Core elements of this phase

1. Multi-method approach

DNB uses a mixture of qualitative and quantitative methods, such as surveys, self-assessments, semi-structured interviews and (board) observations for several reasons. First, the strengths and limitations of various methodologies are recognised and mitigated within a multi-method framework (Denison, 1996). Qualitative methods give insight into how organisational members interpret their experiences and how these interpretations influence their behaviour (Van Muijen et al., 1999). Therefore, these methods are often used to describe and explain organisational culture, especially the invisible aspects. The use of quantitative methods can help to reduce uncertainties and biases related to observations that are inherent in the use of qualitative approaches. Standardisation, processing large amounts of data and quantitative comparison are the advantages of quantitative techniques. More specifically, such research methods help bring depth to studies on the perceptions, thoughts, feelings and behaviour of persons involved.

Second, collecting data based on several methods in a systematic and (semi)standardised way reduces the risk of subjectivity and enhances reliability of the findings. Triangulation is the scientific name of a research approach that uses different tools to substantiate a conclusion from multiple angles (Jick, 1979; Jonker & Pennink, 2000). Although the DNB inspections are not scientific, the reliability of the findings and conclusions is of great importance.

Third, the supervision of behaviour and culture is usually perceived as 'up close' and sometimes confrontational, and the sensitive nature of this kind of supervision is another reason for applying a multi-method approach. The multi-method comparison techniques demonstrate that a more accurate and thorough understanding of organisational issues, particularly sensitive issues, is achieved when multiple methods are used and compared in a systematic manner (Jehn & Jonsen, 2010). Overreliance on a single type of measure or method can seriously jeopardise an accurate interpretation (Folger & Belew, 1985; Jehn & Shah, 1997); therefore, triangulation and a mixing of methods and operationalisation is the optimal solution to the methodological problems involved in the study of sensitive issues, which are more susceptible to misinterpretation (Jick, 1979; Lang, 2007; Webb et al., 1981).

2. Behaviour and culture instruments

a) Further desk research

The objective of this further desk research is to assess the governance relating to a relevant group within the financial institution such as the Board of Directors (including the defined roles and responsibilities, composition, and its decision-making process) in connection with the information on governance of the institution obtained through context analysis (as described above).

- To focus the inspection, we obtain documents on a particular decision (including the decision-making process that was chosen).

The documents that are usually analysed include information on:

- the selected decision, such as minutes of board meetings, scenario planning and SWOT analysis;
- further details on the composition of the relevant group such as the Board of Directors based on regulatory requirements: expertise, skills and professional conduct, availability and independence of directors.

The results of this desk research serve as input for the interview questions.

b) Self-assessment

One objective of the self-assessment is to identify individual perceptions of all board members' decision-making, leadership, communication and the board's group dynamics. Another important objective is that the self-assessment gives board members a sense of the nature and focus of the inspection. The self-assessment contains questions relating to, for example, the degree of reflectiveness and social skills. Usually, on the basis of these individual assessments, several behaviour and culture issues that repeat themselves among all board members are uncovered and form additional topics for the interviews.

The self-assessments are usually completed and returned to us before the interviews start. Still, we sometimes experience that asking these questions is not perceived as common at board level and that board members seem to have trouble completing the self-assessment. On occasion, board members refer to their curriculum vitae or write a letter stating that they do not understand our questions. We think one reason for this is the fact that the financial sector is mainly rational and content-oriented and many board members have come so far because of their technical ability, and not because of qualities such as reflectiveness and social skills. They seem less accustomed to self-evaluation and reflecting on boardroom processes. We generally insist they complete the self-assessment. In our view, (effective) leadership means that leaders address and effectively manage the interpersonal side of their organisation (see Bass, 1990 for a review; Riggio & Reichard, 2008).

c) Interviews

The interview is at the core of our methodology for three reasons. First, it is well-suited to the exploration of attitudes, values, beliefs and motives (Richardson et al. 1965; Smith, 1975). Second, it provides the opportunity to evaluate the validity of the respondent's answers by observing non-verbal indicators, which is particularly useful when discussing sensitive issues (Gordon, 1975). Third, it ensures that the respondent is unable to receive assistance from others while formulating a response (Bailey, 1987). In short, it is very well-suited to an inspection of behaviour and culture.

At banks and insurers, we interview members of the management and supervisory board as well as staff (and sometimes key functions in the three lines of defence). In our inspections of pension funds, we interview board members, assessment committees and participants' councils. We use a semi-standardised interview format with a) a clear set of instructions for interviewers and b) a set of questions on decision-making, leadership, communication and group dynamics. These questions are extensively thought through in advance and serve as a guideline rather than a mandate. In this way, new ideas can be raised during the interview following on what the interviewee says. Generally, the interviewer uses a semi-structured approach and has a framework of themes to be explored. The semi-structured interview is usually accepted as a reliable method for collecting comparable qualitative data (Bernard, 1988). The minutes of the interview are used verbatim as a basis for thorough analysis and to collect quotes.

During the interviews the focus has three perspectives, namely:

- actual behaviour;
- underlying drivers; and
- the sense-making process.

The first perspective concerns the actual behaviour of the interviewee and his/her perception of the behaviour on the board. We distinguish the formal and informal role the interviewee has played in the particular

decision-making process. The formal role is what is expected of the interviewee in terms of corporate (including internal) governance, while the informal role is what the person actually does and does not do. The focus is on the how and what: how does the board reach a decision; what do the interviewee and the board do and why do they do this.

The second perspective concerns the underlying drivers of behaviour, namely group dynamics and mindset. On the basis of examples, the behaviour and group dynamics are examined. This approach resembles the critical incident technique (Flanagan, 1954). A critical incident can be described as one that makes a contribution — either positively or negatively — to an activity or phenomenon. Critical incidents can be gathered in various ways, but typically respondents are asked to tell a story about an experience they have had. We pay specific attention to language – certain jargon or specific words and expressions someone uses – and emotions. Specific words, expressions and emotions can be like crowbars, leading to what's crucial on the 'inside' of the interviewee, and serve as marks of underlying values and assumptions. For example, during a board-effectiveness inspection the word 'respect' was often mentioned and caught our attention. We asked every single board member what the meaning of the word 'respect' was and why it was mentioned so often. It turned out that in terms of team development (see the chapter on group dynamics for a more extensive section on Tucker's model of team development) this board was still in the phase of getting to know each other better and were on the verge of sliding into a next phase with more explicit confrontation. The word respect was an indication of the 'gentle manners' associated with the early stages of team development.⁴

Thirdly, we clarify the sense-making process of the interviewees concerning the actual behaviour, group dynamics and mindset concerning

⁴ These gentle manners were in this particular case assessed by us as a risk, since they hindered plain critique in the board.

what happens in the boardroom. More specifically, we identify behaviour that is considered meaningful, the reason why it is considered meaningful and which behaviour is considered less important. Here, we narrow down contradictions between speech and action and between strategy (or policy) and action, in order to get the most realistic and least socially desirable information.

d) Employee survey

The objective of a survey is to collect a large amount of (quantitative) data. An employee survey is the most 'appropriate when the focus of investigation is at the level of "observable and measurable manifestations of culture", such as values and behavioural norms' (Ashkanasy et al., 2000, p.132). Using a survey, we submit questions to employees at all levels of the organisation in order to collect quantitative data on the perception of decision-making, leadership and communication in the organisation or the perceived effectiveness of a change process. The survey includes closed questions or statements, such as: 'Leaders and managers behave according to the core values of the organisation', and open-ended questions. We use the outcomes of the survey to provide insight into the perceptions throughout the whole or large parts of the organisation.

e) Board observation

The objective of a board observation is to actually see and sense the group dynamics on the board. More specifically, we observe:

- how the board members communicate with each other,
- what the atmosphere is like in the boardroom and
- if there are any distinctive mannerisms.

We attend the board meeting with two colleagues and are not specifically focused on the content of the meeting. Instead, the focus is on the process; how the meeting is held. More particularly, we observe verbal behaviour, such as the way the board members speak to each other, the amount of time someone speaks up and the frequency, the impact of the comments

made and non-verbal behaviour, such as facial expressions, posture, listening behaviour. For example, we sometimes observe one or two people dominating the meeting while other board members hardly say anything. Another example is that we only observe decisions being ticked off with very little dialogue based on different perspectives and arguments. Questions we want to answer during an observation are: How much room is there for divergent views? Who gets the floor from the chairman and who doesn't? Who has the informal leadership and impacts the discussion the most? The chapters on communication and group dynamics will elaborate on these topics more extensively.

Board observations are a controversial part of the behaviour and culture inspections. We note that the observations take place fairly naturally. Alex Wynaendts, CEO of Aegon, who experienced a board meeting during one of our investigations, told the news magazine *Vrij Nederland* (February 2, 2013): 'I must honestly say that I had wondered if this would work out, but within a few minutes it was a totally normal meeting.' And he was pleased to hear from outsiders how they experienced the interaction and atmosphere in his organisation. 'It provides an opportunity to learn and develop,' he said. Of course observing one board meeting isn't enough to draw major conclusions. Our experience is that a board observation solidifies the image that emerged using the other instruments. As such, this observation provides useful additional information and is often held in the latter phase of the inspections.

On the basis of this multi-method framework, we collect the data and in the next phase of the inspection we assess our findings, as described in the next section.

4.7 Behaviour and culture risk assessment - what do we see?

Purpose

During the phase of risk assessment, the purpose is to determine the nature and the extent of the identified risks.⁵ This is generally done using the following set-up: working from an individual perspective on the data collected towards a group perspective and then challenging the inspection team's assessment based on the findings (see five steps in Figure 4.4).

Figure 4.4 Core elements of this phase



Step 1 – individual structuring of findings. The starting point of every assessment on behaviour and culture is an individual structuring by the interviewer of the findings in the categories decision-making, leadership, communication and group dynamics. Behavioural patterns are then extracted on the basis of behaviours that appear repetitive and are recognised in several methods. Finally, the behaviours and behavioural patterns are classified in terms of strengths and weaknesses/risks.

Step 2 – group structuring of findings in terms of risks and priorities. Only if several instruments provide matching images of the collected data and we detect behavioural patterns based on several tools, we will accept this as a conclusion. During step 2 the team builds their professional judgment,

⁵ i.e. the behaviours and behavioural patterns that are classified in terms of strengths and weaknesses/risks.

working its way from the above-mentioned individual findings to a team (i.e. inspection team) conclusion concerning the following topics:

- what are the findings on the current behaviour and behavioural patterns in terms of decision-making, leadership, communication and group dynamics;
- what are the risks and positive consequences or effects of these behaviours; and
- what kind of behavioural patterns and behavioural determinants can explain the behaviours.

Step 3 – challenging the findings. During every inspection we organise several challenge sessions, with the objective of presenting and challenging the data in terms of the identified behavioural patterns and the associated risks. Fellow supervisors from different backgrounds challenge and question us on the observations and structuring of these findings in the behavioural categories. These are supervisors from ongoing supervision who are not participating in the inspection, as well as supervisors from the Authority for the Financial Markets (AFM), the Netherlands' other supervisor of the financial sector.

We invest a significant amount of time in these peer challenges. Cornerstones of these sessions are the four-eyes principle and diversity in perspectives to manage the inevitable imperfections of professional judgement. Like every professional judgment, human 'knowledge' about reality is always subjective, relative, incomplete, and to some extent biased (Kahneman, Slovic & Tversky, 1982). A supervisor's professional background (such as psychologist, lawyer, business management and other work experience) and personal background (life experiences, family and education, partner, gender and age) will affect the interpretation of the observed behaviour. Every supervisor has his or her own perspective and biases. Consequently, our inspections and challenge sessions are rooted in the mindset that supervisors are also subject to human imperfections.

We believe that awareness of this is key to managing and mitigating the impact of bias (or distortions of reality) on professional judgment. Therefore, individual positions are first explained and then questioned and challenged in a group. Being aware of the inevitable human imperfections, we manage them using three 'ground rules':

- work from an individual angle towards a team judgment;
- manage the degree of inevitable subjectivity by thoroughly explaining facts and assumptions;
- foster and use diversity in the challenge sessions.

Step 4 – the assessment is finalised by the inspection team. This final assessment involves drawing a final conclusion in terms of three risk categories: red, orange and green (see Table 4.2).

The final assessment or conclusion about the behaviour or culture leads to the intervention or control strategy for the institution concerned. After all, we aim to influence behaviour and culture; the ultimate goal is not the diagnosis (this will be explained in the next section on risk mitigation).

Step 5 – the final assessment is challenged once again, (see step 3).

Table 4.2 The three risk categories on behaviour and culture

Risk category	Red	Orange	Green
Timing of intervention	Interventions in behaviour and culture are necessary on a short-term notice	Interventions in behaviour and culture are necessary for a middle-term period	Interventions in behaviour and culture are not necessary for a middle-term period
Effective supervisory strategy	Formal actions to uphold short-term changes	Transfer of supervisory norms and expectations	Appraisal and confirmation
Supervisory Mindset	(healthy) Suspicion	Educate and direct	Trust
Effective supervisory behaviour	<ul style="list-style-type: none"> • Clear setting of boundaries • Direct and confrontational • Focus on risks • Raising pressure, force if necessary 	<ul style="list-style-type: none"> • Focus on risks • Appraise strengths • Confrontational and setting boundaries concerning the risks • Dialogue and provide insight and direction concerning behavioural change and improvements 	<ul style="list-style-type: none"> • Dialogue • Focus on strengths and communicating appraisal • Make concrete arrangements to maintain positive trend

4.8 Behaviour and culture risk mitigation - what do we expect?

Purpose

During the mitigation phase, the aim is to reduce or solve the assessed risks. There are many different books, models and theories on learning how to effectively influence behaviour and culture within organisations and boards. Still, despite all these models on cultural change, there is no 'one golden intervention' that is appropriate in all cases. We define risk mitigation for behaviour and culture as choosing interventions that lead to effective and sustainable changes in behaviour, group dynamics and mindset; these changes will eventually contribute to the mitigation of prudential risks.

DNB is convinced that behaviour and culture can be influenced and we expect financial institutions to work on their culture and behaviour. This means supervisory interventions should be directed in any event at changing behaviour and group dynamics at the top of financial institutions, i.e. the board and senior management. It also implies supervisory interventions focused on effective leadership of the board concerning the necessary behavioural and cultural changes within their financial institution.

Core elements of this phase

We consider the following to be crucial in the mitigation phase:

1. the primary objective is to challenge and change ineffective drivers of behaviour and culture risks;
2. the preferred communication style for influencing risky behaviour and culture is a challenging dialogue;
3. the intervention strategy is based on multiple and multilevel interventions instead of just one;

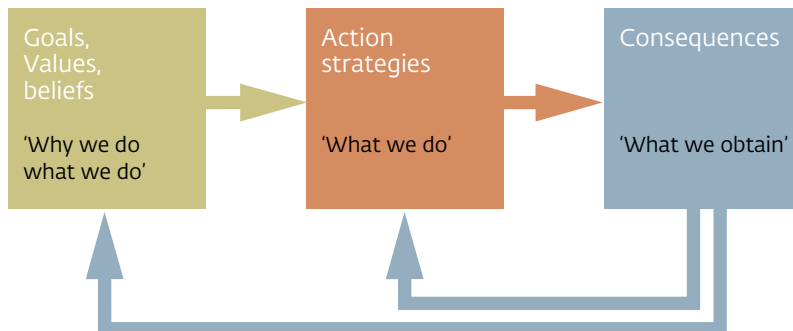
4. changing behaviour and culture requires perseverance, from the financial institution but also from supervision. The focus should not only be on quick wins (see Tushman & O' Reilly, 2002) but long-term effects and monitoring by the supervisor to ensure sustainable changes are realised.

1. Challenge and change ineffective drivers of behaviour and culture

The purpose of the supervision of behaviour and culture is to ensure and promote a situation where the behaviour of directors, auditors and employees of financial institutions, as well as the culture of those institutions, does not detract but contributes to the financial performance, the soundness and integrity, and the risk profile of the institutions. Raising the bar for sound practice requires a level of conscious competence. A crucial step in the mitigation phase is challenging existing drivers of the behaviour of key figures that are risky and impede group performance (such as the board) and, ultimately, the institution's performance.

To establish effective and sustainable behavioural change, congruence is needed between 'what people think they are doing' and 'what they actually do'. The work of Argyris and Schon (1974) is relevant here. They devoted decades to studying conscious and unconscious processes that impact learning and development in organisations. A key finding of their work is that a) most people's intentions and beliefs about what they are doing bears little resemblance to their actual behaviour and b) that most people are unaware of this discrepancy or incongruity. As a result, many people learn at a superficial level (also called single-loop learning: Argyris, 1974 or First Order Change: Watzlawick et al., 1974) and fail to effectively and profoundly change their behaviour ('double-loop learning' or Second Order Change, See Figure 4.5).

Figure 4.5 A schematic view of single and double-loop learning.



First order change or single-loop learning means that the existing standards and principles remain the same and that change occurs within those standards. One example would be an executive board that is struggling with disappointing results, which continues to use the same business model and, from within that framework, seeks to invest in other portfolios. Second order change or double-loop learning means that the underlying norms and principles are questioned. And, in the example, that the business model is questioned. This is the reason why the rigorous challenge of the drivers of behaviour – meaning the patterns of behaviour, group dynamics and beliefs – is a central and crucial part of the feedback session with the institution.

Any contact with a financial institution involves a supervisory responsibility to test and/or enhance the awareness concerning behaviour and culture. More specifically, we question whether boards are able to reflect on their behaviour, group dynamics and mindset in relation to the performance of the board and the organisation. Do they acknowledge the (potential) risk of behaviour and culture as regards the performance of the board and the organisation? And is the board willing to work on effective, sustainable

mitigation of these risks? In other words, can fundamental beliefs, group dynamics and behaviours that are risky or unsound be questioned and challenged? Reflection, acknowledgement and willingness are key focus points in our mitigation strategy. Theories on organisational learning and group development confirm the importance of these points (see, for example, Maslow's four stages of learning, 1954; Argyris & Schon, 1996).

In our supervision, we differentiate between three mitigation strategies (see section 4.7 on assessment of behavioural and cultural risks where we introduced the three risk categories red, orange and green). Every category requires a different approach to establish effective learning and to change behaviour. Red occurs whenever a board is unable to challenge its beliefs and does not recognise risky or unsound behaviour. In this context, Maslow (1954) refers to unconscious incompetence, which can be due to a blind spot or resistance. So in the case of the absence of reflection and recognition, the red category applies, immediate action is required and short-term changes are necessary. In this phase, learning basically has no priority. It is all about intrusive supervision and boosting pressure on the financial institution in order to intervene and act upon the behavioural and cultural risks. In the green category, the behaviour and culture in the financial institution raise no concerns for the supervision and provide comfort and trust. Supervisory mitigation focusses on appraisal and confirmation through an open and reflective dialogue with the institution.

The most complex category in terms of risk mitigation is orange. For the institutions in this category, serious risks are identified which require a sustainable mitigation strategy and should not be ignored. Yet, these risks have usually not materialised into major financial problems (otherwise they would be in the red category). Therefore, the detrimental effects of these risks are less visible, especially if the institution is unaware of its incompetence and supervision is pointing to a blind spot. The effective supervision strategy in this category is the transfer of supervisory norms

and expectations through challenging dialogue. This involves questioning fundamental assumptions on the institution's behavioural and cultural (or social) norms, raising awareness of blind spots and risks and being explicit about expectations concerning effective, sustainable mitigation.

2. Challenging dialogue: the preferred supervisory communication style

Using challenging dialogue for intervention is key to DNB's supervision of behaviour and culture. We focus less on information transfer through reports, letters and fact sheets, which are usually aimed at convincing the other in an analytic manner. Instead, we opt for direct communication with the objective of raising awareness and recognition, challenging beliefs and social norms, and we expect boards and directors to get involved and take ownership for the behaviour and culture risks we address. John Kotter's (2008) distinction between a see-feel-change approach and an analyse-think-change approach is relevant here.

See-feel-change revolves around creating a clear and appealing visualisation or experience of the problems and solutions, which evokes feelings that contribute to change - such as urgency, optimism and faith. Furthermore, feelings that hinder change, such as anger, complacency, cynicism and fear, should be tempered. Through this see and feel approach, behavioural change is put in motion and new behaviour is encouraged. According to Kotter, this approach plays a central role in organisations that are successful in implementing change. Analyse-think-change refers to collecting and analysing information, writing reports and giving presentations in such a way that people start to think about - as opposed to feel - the needed change and conclude that they must change their behaviour. According to Kotter, this rational, cognitive approach is rarely applied in companies that are successful in implementing change (Kotter, 1997; Kotter & Cohen, 2002; Kotter, 2008).

Our mitigation strategies to create awareness and strive for ownership are also based on the notion that sense-making is an important human need in organisations. Sense-making refers to framing situations as meaningful (Cartwright & Holmes, 2006; Van Vuuren & Elving, 2008; Weick et al., 2005). In organisations, the strategy, business model, governance structures and processes are aligned towards overarching organisational goals. Ideally, everything in an organisation is pointing in the same direction. But reality is much more complex and, particularly in uncertain and ambiguous situations such as behavioural and cultural change processes, sense-making is an important psychological process that can guide behaviour. "Situations, organizations and environments are talked into existence" (Weick et al., 2005, pp. 409). Sense-making involves language, talking and communication; it increases whenever people speak and narrate. According to Weick (1995), sense-making concerns the interplay of action and interpretation. In other words, sense-making is built on dialogue. Through confrontational dialogue we tap into board members' need to make sense of our message and the expectations we have concerning their behaviour and culture.

A final rationale behind the challenging dialogue is the fact that supervisors are seldom perceived as neutral by financial institutions. Usually, supervisors encounter a healthy sense of suspicion or mistrust and operate in a defensive communication climate (Robertson, 2003). This means that board members (as well as supervisors) do not have the feeling they can speak freely. This is understandable, since supervision implies that the financial institution is dependent on the supervision. In addition, the fact that the financial sector is 'on the spot' – as is currently the case with society's lack of trust in the financial sector – can amplify a defensive reaction. Whether this defensive reaction is justified or not is irrelevant to the supervisory task of mitigating behavioural and cultural risks. Dialogue is usually the most direct and effective way to tackle defensiveness and resistance.

3. Multiple and multilevel mitigation strategies

Psychological literature on learning and development shows three dominant approaches to challenging and changing behaviour (see Gross, 1996; Huczynski & Buchanan, 2001; Sarafino, 1996; Tiggelaar, 2010). The first is conditional learning or learning through environmental stimuli. Stimuli or conditions in our direct environment guide or direct human behaviour, either through antecedents – stimuli prior to behaviour – or consequences – stimuli following behaviour. The second is social learning or modelling. Behavioural change occurs through observing and imitating the behaviour of others. And the third is cognitive learning, whereby people learn and change mainly through thinking and reasoning.

Recently, a dual system approach has surged in popularity, which provides a synthesis or 'fourth way'. The dual systems approach is based on the premise that two systems (or a set of subsystems) interact in the human brain, namely a system focused on intentional or deliberative brain processes (emphasising planned and conscious behaviour based on intentions and beliefs) and a system focused on unconscious and unintentional brain processes (emphasising automatic behaviour based on external stimuli). The automatic, unconscious system is generally seen as strongly dominant over the planned, conscious system (see, for instance, Baumeister et al., 1998; Chartrand & Bargh, 1999; Dijksterhuis, 2004; Dijksterhuis & Meurs, 2006; Kihlstrom, 1999; Ouellette & Wood, 1998; Wilson, 2002).

Even though the dual system approach is quite mainstream within the field of psychology, it is still an emerging topic in other management and organisational disciplines and new to supervision. However, we believe it is relevant to supervision because of the complexity of influencing and changing behaviour and culture in financial institutions. This complexity requires mitigation approaches that incorporate multiple approaches,

conditional, modelling and cognitive as well as conscious and unconscious systems, to behavioural change. Choosing just one approach, such as focusing only on changing behaviour through external stimuli such as financial bonuses, is less effective.

4. Challenging culture and behaviour risks requires perseverance

It takes a lot of persistence and discipline to supervise behaviour and culture. More specifically, to address the blind spots that are usually deeply rooted, unconscious and persistent. This endurance is related to the function of organisational culture, namely the standardisation of problem solving and the reduction of insecurity (Hofstede, 1986; Sanders & Neuijen, 1987; Schein, 1992). Organisational cultures arise out of the survival struggle in the early days of an organisation and tackling the tough times thereafter. This results in a collective way of thinking and doing. And organisations usually hang on to problem solving methods that were effective in the past – and which resulted in persistent behavioural patterns – even when they are no longer effective (Schein, 1992). Once behaviours and behavioural patterns have developed, they will generally be persistently maintained, because people have a natural need for stability and predictability, which is associated with the basic need for security. Relapsing into old habits is one of the conservative characteristics of all cultures (Straathof, 2009). Challenging behaviour and culture means questioning underlying beliefs and threatening stability and security. These kind of changes in organisations often involve an emotional and confusing process. Not only for the financial organisation's leaders and managers but also for the supervisors who address issues concerning behavioural and cultural change. All in all, this requires perseverance.

Summary of the mitigation phase

In summary, the mitigation strategies in our supervision are based on a mixture of multiple (conditional, social and cognitive learning) and multi-

level (conscious and unconscious) interventions. During the feedback session, the focus is on achieving commitment and engagement. We do this by:

- Identifying risks and strengths in terms of behaviour and group dynamics;
- Clarifying what we expect in terms of desired and undesired behaviour and group dynamics;
- Requiring sustainable, multilevel interventions in terms of behaviour and group dynamics;
- Monitoring the efforts and tangible effects of the interventions implemented at financial organisations.

These points are addressed in a challenging dialogue with the financial institution's board. This dialogue is key to our supervision of behaviour and culture and our intervention strategy. In the chapters on decision-making, leadership, communication and group dynamics, examples of such mitigation strategies are described with examples based on our supervisory experiences.

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Rationale for supervision on behaviour & culture

Model & Basic
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Part II

Our Practice

Chapter 5-10



Decision Making

5.1 Introduction

The quality of decision making in financial institutions plays an important role in DNB's supervision of behaviour & culture. This is why decision making is one of the key elements of our supervisory framework in addition to leadership, communication and group dynamics, and our supervisory inspections include careful scrutiny of past decisions.

The reason for this emphasis is that decision making is among the core activities of management boards. In the end, all decisions taken together to a large extent determine the future success and financial solidity of organisations (Finkelstein, Hambrick & Cannella, 2009; Veltrop 2012). Consequently, insight into the quality of the decision making process at board level is among DNB's core supervisory objectives.

Our focus on decision making is also explained by the fact that making effective decisions is a complex and demanding task. Boards often have to make decisions under uncertain circumstances and on the basis of incomplete information, requiring close cooperation between people with various backgrounds and experiences. At the same time, the context in which financial organisations are required to operate is changing swiftly, due to uncertain economic circumstances, rising stakeholder expectations and technological innovations. This growing complexity has made decision making error prone, which the financial crisis has proved.

This is why DNB stresses the importance of sound and effective decision making within and by financial institutions. As in all organisational teamwork, effective group/board decision making depends on a well-tuned interplay between structural and organisational design and human behaviour. DNB's supervision therefore examines the quality and effectiveness of both structural and behavioural aspects. This chapter discusses how DNB performs its inspections. Section 5.2 deals with the assumptions underlying our approach. In section 5.3 we will describe how these assumptions translate into our assessment method. Section 5.4 elaborates on our inspection findings, whereas section 5.5 describes what financial institutions could do to mitigate risks pertaining to decision making. Section 5.6 provides a short summary.

5.2. Assumptions

DNB's supervisory method with respect to decision making is based on five elements, which have implications for the scope and depth of our inspections. These elements are

- Governance requirements
- Decision effectiveness
- Challenges for decision making amid increasing complexity
- Perspectives on decision making
- Constructive challenge is crucial to effective decision making

¹ Although there is a difference between groups and teams, for the purpose of this chapter, we will use both notions indiscriminately. All teams are groups and have the basic characteristics of any group: interaction, goals, interdependence, structure and unity. However, these characteristics have more intensity in team contexts (Forsyth, 2010).

Governance requirements and effectiveness

Since the end of the last century, various corporate scandals have prompted the development of national and international governance frameworks and financial regulations, describing how organisations and financial institutions should be structured to enhance their performance. Since the last financial crisis, these frameworks have reflected the growing awareness of the importance of behaviour for effective governance.

International financial regulations stress the importance of sound and effective decision making (see Table 5.1). To achieve sound and effective decision making, boards should be adequately organised and demonstrate effective behaviour. For example, boards are required to have an adequate size, composition and combination of expertise, whereas their individual members must devote sufficient time to the performance of their duties. In addition, roles must be clearly defined and decisions must be taken based on high-quality and promptly obtained information. Board members are expected to engage in a constructive debate, in which they are given the opportunity to critically challenge each other's positions and opinions prior to taking decisions.

DNB takes these provisions as the starting-point for its supervision on decision making. However, they not only have legal value. As will be demonstrated below, these provisions reflect phenomena that are identified by scientific research as important determinants of team behaviour and performance. As such, the governance and organisational psychology perspective coincide.

Table 5.1

Governance requirements²

Members of the management board must make sound, objective and independent decisions.	BCBS par 59 EBA 12.1 IAIS 7.3 and 7.4
A board must be composed in such a manner so as to include the appropriate level of knowledge, expertise, and diversity and with a sufficient number of independent members (board composition) in order to ensure such sound and effective decision making.	BCBS par 46/47 EBA 12.1 and 13.2 IAIS 7.3.1, 7.3.2 and 7.3.8 EIOPA 1.31 and 1.32
Board members with conflicting interests should be transparent about these conflicts and should under certain circumstances abstain from decision making.	BCBS par 82 EBA 12.6 IAIS 7.3.3
Boards should encourage an ethical culture in which challenges can be openly expressed.	BCBS par 30 EBA 12.1 IAIS 7.2.4
The chairman of the board must ensure such effective and sound decisions, in particular by encouraging and promoting critical and constructive debate and a free flow of (dissenting) views during the decision making process. To challenge the management is perceived to be one of the most essential duties of non-executive/supervisory board members.	BCBS par 59 EBA 10.2a and 14.4 IAIS 7.3.6
The nomination committee should ensure that the management's body decision making is not dominated by any one individual or small group of individuals in a manner that is detrimental to the interests of the institution as a whole.	BCBS par 87 EBA 24.3 IAIS 7.3.9 EIOPA 1.28

² The frameworks referred to in this table are: 1. Guidance on Corporate governance principles for banks, Basel Committee on Banking Supervision, Consultative Document October 2014. 2) EBA Guidelines on Internal Governance (GL 44), European Banking Authority, September 2011. 3) Consultation papers on Revision of Insurance Core Principles 7 and 8, and 4) Guidelines on System of Governance, European Insurance and Occupational Pensions Authority, 2013.

Decision making of senior management should be clear and transparent and must provide clarity on the role and authority of the various positions within senior management, including the CEO.	BCBS par 114 CRD IV 88.2 IAIS 7.0.2 and 7.3.12
The (management and supervisory) board must be provided with all information that is needed to enable good business judgements and critical challenge. Information must be presented in such a manner that it is timely, understandable, comprehensive, yet not voluminous nor overwhelming in detail.	BCBS par 93 EBA 10.4, 24.3 and 26.2 IAIS 7.4.2 EIOPA 1.17
The risk management function must be able to influence and challenge material risk decisions.	BCBS par 103 EBA 26.1 Solvency II 44.1

Decision effectiveness

DNB's supervision of behaviour and culture considers balanced and consistent decision making as two essential building blocks of an institution's effectiveness³. Balanced decision making refers to the extent to which the risks and short and long-term interests of all stakeholders of the institution have been identified, carefully weighed and visibly taken into account in the decision making procedure. Consistent decision making is defined as the extent to which the institution and the people working for it act and take decisions in accordance with its strategic long-term objectives.

³ Balanced and consistent decision making have been included in supervision since DNB's 2009 policy vision: "The 7 elements of an ethical culture".

The relevance of balanced and consistent decision making is based on three assumptions. The first of these is that financial institutions can only achieve solid long-term performance and financial performance by carefully considering the interests of all stakeholders. Second, balanced decision making prevents that decisions are taken prematurely and based on incorrect or incomplete information and assumptions. And finally, institutions have to be constantly aware of possible changes in the environment in which they operate. They must adapt to these changes to remain successful. It is important that board members create a clear and shared understanding about the institution's environment, its "fit" with this environment (Van der Heijden, 2011, p.7), and how to adapt to changing circumstances (Kozlowski & Ilgen, 2006)⁴. Such accurate shared mental models help boards to adapt to changing circumstances and lead to effective and efficient coordinated management of group behaviour⁵. Hence, shared mental models contribute to effective decision making (Burke, Stagl, Salas, Pierce & Kendall, 2006; Edwards, Day, Arthur Jr. & Bell, 2006; Espinosa, Lerch & Kraut, 2004; Kozlowski & Ilgen, 2006; Lim & Klein, 2006; Marks, Mathieu & Zaccaro, 2001; Mathieu, Maynard, Rapp & Gilson, 2008; Mathieu, Heffner, Goodwin, Cannon-Bowers & Salas, 2005; Mohammed, Ferdandi & Hamilton, 2010). This is particularly important in complex situations, which will be discussed in the next section.

4 This situational awareness is relevant, because boards do not operate in isolation. As the environment constantly changes, the group constantly "reacts to the environment and may to some extent change it" (Wittenbaum et al., 2004, p. 27; Homans, 1950, p.90 and 91). The team's ability to adapt to the changing environment plays an important role in predicting group performance, and as such also has an impact on the quality of decision making (Burke et al., 2006; Marks et al., 2000; 2001). Translated to boards of financial organisations, they have to deal with (the interests of) internal and stakeholders (e.g. employees, shareholders, financial analysts, clients, creditors, financial supervisors, the public), commercial challenges and competition.

5 Behavioural coordination involves "the process of orchestrating the sequence and timing of interdependent actions. This refers to the management of synchronous and/or simultaneous activities, information exchange and mutual adjustment of action in order to align the pace and sequencing of team member contributions with goal accomplishments" (Marks et al., 2001, p.367 and 368).

Complexity

Making effective decisions is not an easy task. Decision makers in the financial sector are confronted with various challenges. One of these is complexity, which is caused by several factors. First of all, the financial sector is inherently complex (FSA, 2009). This is due to market volatility, the nature of financial instruments and transactions, rising shareholder and stakeholder demands, coordination problems due to the institution's size and global presence, as well as the dynamic economic climate. All these factors taken together create uncertainty as well as a large number of very diverse risks.

In addition, board decision making in itself is a complex task (Gouran & Hirokawa, 1996; Kolbe & Boos, 2009; Orlitzky & Hirokawa, 2001). According to Kolbe and Boos (2009) this is because:

- it is often unclear which objectives the decision is designed to accomplish and how this should be done (ambiguity) (see also Orlitzky & Hirokawa, 2001);
- information is often incomplete and/or unevenly distributed across the members of the group (who often have diverse backgrounds and experiences), and
- selecting a decision option requires evaluative judgement or a "judgement call", whereas at the same time the correctness of such a judgement cannot be objectively established (as a consequence, different individual opinions, preferences and evaluation criteria need to be discussed) (see also Stasser & Dietz-Uhler, 2001).

The above factors cause challenges to decision making (e.g. Hambrick, Finkelstein & Mooney, 2005). As each board member holds a piece of the information, group members must share their diverse knowledge and cooperate closely in order to accomplish their tasks effectively (Mathieu et al., 2008; Amason, 1996). Problem analysis, mutual understanding of members' roles and responsibilities, coordination and behavioural

coordination and communication all impact effectiveness, especially in cases of high member interdependence⁶ (Burke et al., 2006 and 2006(1); Espinosa et al, 2002; Gouran & Hirokawa, 1996; Ilgen, Hollenbeck, Johnson & Jundt, 2005; Kozlowski & Ilgen, 2006; Marks et al, 2001; Orlitzky & Hirokawa, 2001; Saveedra et al., 1993; Tesluk & Mathieu, 1999; Zaccaro & Bader, 2003). The question then is how these challenges relate to decision making. This is the subject of the next paragraph.

Perspectives on decision making

DNB's approach to decision making combines two apparently opposite scientific perspectives. The first advocates that optimum decisions can best be achieved by means of structured processes. There is extensive scientific research available demonstrating that groups are more likely to make better decisions if they follow a methodical or structured decision making process in order "to enhance the way they gather, analyse and weigh information" (Forsyth, 2010, p.316; see also Bazerman & Moore, 2009; Gouran & Hirokawa, 1996; Russo & Schoemaker, 2002; Wittenbaum et al., 2004). Problem analysis, process planning and especially the assessment of negative consequences of alternative solutions are important decision activities (Burke et al., 2006; Ilgen et al., 2005; Orlitzky & Hirokawa 2001).

Contrary to the advocates of rational decision making⁷, another school of thought works under the assumption that "complex decisions are

6 Task interdependence can be defined as "the degree to which group members must rely on one other to perform their tasks effectively given the design of their jobs". (Saveedra et al, 1993, p. 61; see also Burke et al, 2006(1), p. 294).

7 An important school with respect to rational decision making is the functional theory of decision making (Gouran & Hirokawa, 1996). Despite its focus on the performance of decision tasks, it would be unfair to say that the functional theory of group decision making dismisses the relevance of behavioural factors. The theory acknowledges that decision making may be impaired by cognitive, affiliative and egocentric constraints and that group members should employ appropriate interventions for overcoming them. Affiliative constraints, for example, could relate to an uneven participation of group members or the pressure to conform (see also section 5.3). The theory also rests on the assumption that decision making effectiveness is affected by communication behaviours of the various group members. Communication may affect the various decision tasks/activities in three ways: 1) promotive, allowing the group to successfully accomplish the decision tasks, 2) disruptive, creating obstacles for the successful completion of such tasks, and 3) counteractive, neutralizing a disruptive communicative act.

largely the outcome of behavioural factors rather than a mechanical quest for economic optimisation”, whereby “the more complex the decision, the more applicable this behavioural theory is thought to be.” (Hambrick & Mason, 1984, p.194). Limited cognitive abilities, conflicting goals, varying aspirations levels and personal values distort an individual's judgements and make optimum rational decision making difficult to achieve (Hambrick & Mason, 1984). The above is especially valid for decision-makers working in upper-level positions, as they are confronted with more complexity and stimuli than they are able to handle from a rational perspective. The resulting use of cognitive shortcuts and human judgement in order to make decisions, makes it hard for people to fully rationally account for their decisions. This gives rise to mistrust about people's motives and hence may lead to (personal) conflict between group members (Hambrick et al., 2005; Mooney, Holakam & Amason, 2007).

Most decisions taken in financial institutions are taken by groups like management boards and risk committees. Groups may be subject to a range of distortions causing them to perform worse than the sum of their individual members (De Dreu et al., 2008). These distortions (such as conformity pressures and conflict)⁸ tend to have adverse effects on essential decision making activities, most notably on the exchange of views and opinions between group members (Baron, 2005; Gouran & Hirokawa, 1996; Nemeth & Nemeth-Brown, 2003). This group perspective explains why DNB's approach focuses on group behavioural patterns (see paragraph 5.3). Furthermore, individual cognitive limitations can only be compensated for by group interaction; they cannot be corrected effectively at an individual level (Fischhoff, 1982; Gouran & Hirokawa, 1996; Kahnemann, 2003; Larrick, 2004). As such, it serves no supervisory purpose to focus on decision making on an individual level.

⁸ Of course there are more group dynamic patterns than the ones mentioned in this chapter, such as group think and social loafing. These patterns are discussed in Chapter 8 (Group dynamics).

At DNB we are convinced that effective group decision making depends on well-tuned interplay between structural design of decision making and human interaction. This means that our supervisory approach to decision making acknowledges the structural design, in line with the first perspective discussed above. We also focus on the group behavioural aspects of effective decision making, which is in line with the second discussed perspective. More specifically, in the risk identification and assessment phase, DNB's supervisory approach predominantly focuses on group behavioural patterns that hamper effective decision making (see paragraph 5.3). In the mitigation phase however, we add the focus on structural design to prevent decision risks that are caused by impairing behavioural patterns. In this respect, we believe that a constructive exchange of ideas and opinions between the members of a group is essential to effective decision making. This essential role of constructive challenge is the subject of the next section.

Constructive challenge

In line with financial regulation's emphasis on challenge (see Table 5.1), DNB holds the position that constructive challenge is essential to effective decision making. Whereas diversity in knowledge and experiences creates the basis for effective decision making, its potential is best realised through the process of 'critical and investigative interaction processes' (Amason, 1996, p.124). In short, challenge constitutes having a critical debate – on the basis of accurate information – between group members, in order to discuss the facts and assumptions that underlie the decision. It implicitly includes activities such as information gathering, the exchange of perceptions and opinions and the examination of negative consequences of decision alternatives. Such debate leads to better decision making by "forcing teams to accommodate and synthesize multiple points of view" (Mooney et al., 2007, p.733) into a common position that "mirror[s] the true state of the world" (Edwards et al., 2006, p.728).

The importance of constructive challenge in terms of effective decision making can hardly be stressed enough. Take for example RBS's dramatic decision in 2009 to take over ABN AMRO together with Fortis and Santander, which decision was evaluated in a 2011 FSA report:

"The risks that can emerge when there is a dominant CEO are not merely ones of difficult relationships between the CEO and the board, staff, shareholders and regulators. More seriously they can also result in a lack of effective challenge by the board and senior managers to the CEO's proposals, resulting in risks being overlooked and strategic mistakes being made."

"However, despite [] adherence to formal process, [] the review team has not found evidence that the board undertook any penetrating analysis of the risks on an enterprise-wide basis in respect of capital and liquidity. [] One former board member reflected, with hindsight, that there was an element of "group-think in the board's decision to take over ABN AMRO []." In summary, the review team concluded that the judgement of the RBS Board in respect of the takeover of ABN AMRO was not characterised by the degree of moderation and sensitivity to strategic risk appropriate to a bank. With so much at stake, there was a critical need for more fundamental probing, questioning and challenge by the board.

Scientifically well-established phenomena like task conflict and dissent emphasise the same features. Task conflict "promotes the exchange of ideas, the surfacing of assumptions, and the synthesis of various perspectives into balanced and well-reasoned decisions" (Mooney et al., 2007, p.734). Through cognitive conflict "conventional thinking is challenged,

threats and opportunities are identified and new solutions forged (Amason 1996; De Dreu, 2006; Jehn et al., 2008; Mooney et al., 2007; Schultz-Hardt et al., 2002; Tjosvold, 2008, p.21; see also Tjosvold, 2006; Russo & Schoemaker, 2002).” Task conflict may facilitate an exchange of information and ideas that is crucial to superior group outcomes” (De Wit, Greer & Jehn, 2012, p.364). On the same note, dissent is known to liberate individuals from the tendency to conform, encourages others to contribute their own points of view to the discussion and stimulates “thought that considers more information and more opinions and culminate in better decision making and productivity” (Nemeth & Nemeth-Brown 2003, p. 64). Dissent stimulates thinking about an issue from various angles (Rispen, 2014; Nemeth, 1986) and manifests itself in information search, thoughts about an issue, and the detection of creative solutions (Nemeth & Nemeth Brown, 2003; Nemeth, Brown & Rogers, 2001; Nemeth, 1995). Groups are perceived to make better decisions when a minority viewpoint is “consistently maintained” (Nemeth & Nemeth-Brown, 2003, p. 73; see also Shultz-Hardt et al, 2002).

Extensive scientific research has proven the point that task/cognitive conflict in general contributes to problem solving and decision making. However, not all conflict/challenge is constructive. If not managed adequately, cognitive conflict may for example spark negative emotions, which may cause escalation into emotional conflict (Jehn et al., 2008; Rispen, 2014)⁹. This type of conflict is generally perceived to impede

⁹ De Dreu (2006) found that increases in intragroup conflict leads to more innovation and problem solving, but only up to a certain point. Passing this threshold, would mean that a greater amount of conflict would reduce team performance. This is another argument that conflict must be controlled to prevent it getting out of hand. On the other hand top management teams are perceived to be less vulnerable to several types of conflict. Their members are thought to be more politically savvy and better able to deal with interpersonal conflicts (De Wit et al., 2012; Lazear & Rosen, 1981). This appears to contradict the observation made above that the evaluative nature of upper level decision makers’ tasks, tend to give rise to mistrust and hence conflict (Mooney et al, 2007). Given the fact that extensive research indicated there may be numerous situations in which task/ cognitive conflict may spark off ineffective emotional conflict, we adhere to the position that task conflict may be advantageous, provided it is adequately organised.

decision making. Separating both types of conflict is important in order to come to effective decisions. This may be accomplished through mutual trust, group norms about conflict and certain leadership styles. We will explain these aspects in section 5.5, which deals with risk mitigation. First, however, we will turn to the topics included in DNB's risk identification approach.

One final remark, however, must be made. It refers to whether the above observations have cross-cultural validity. Obviously, cultural differences may result in different approaches to conflict. It appears likely that conflict is more acceptable in "uncertainty-accepting cultures (compared to uncertainty-avoiding cultures)" (De Wit et al, 2012, p. 364). Furthermore, European Americans appear to have a more competing style when addressing conflict, than individuals who are raised in cultures with more collectivist traditions (De Wit et al., 2012). Scientific analyses, however, indicate the existence of a positive relationship between task conflict and group performance (e.g. in terms of decision making), irrespective of the cultural context (De Wit et al., 2012). This observation is especially valid for international supervisors who aim to integrate behaviour and culture into their supervisory approach on decision making.

5.3 Risk identification¹⁰ - what are our points of interest?

DNB's assessment method can be captured in the following table, which includes the elements that are subject to risk identification in combination with its indicators, which will be explained in this section.

¹⁰ Scientific research demonstrates that the quality of decision making is impacted by many of factors (for an overview see for example De Dreu et al., 2008). It is impossible and impracticable to include them into one supervisory approach. We have selected the factors that match the combination of presence in regulatory frameworks, material and observable impact on decision making and receptive to interventions.

Table 5.2

Behaviour & culture focus in decision making	Indicators
A. Structural factors	
A1 Role clarity	<ol style="list-style-type: none"> 1. Board members understand their roles and the resulting level of engagement and cooperation. These roles and level of engagement respond to the needs of the organisation (given the situation it is in). 2. The board collectively translates the understanding of its role and intended cooperation into clearly defined duties and responsibilities that are consistent with the size, nature and complexity of the institution.
A2 Meaningful involvement of all relevant people and functions	<ol style="list-style-type: none"> 1. The decision making process facilitates prompt and meaningful contributions by all relevant people and functions. 2. Contributions made by these people and functions are digested and included in decision reports.
A3 Quality of information	<ol style="list-style-type: none"> 1. Information must be provided in such a manner that it deepens the understanding of the issue at hand and enhances constructive challenge. 2. Decision materials are i) comprehensive, yet concise, ii) include priority lists and are presented in context, and iii) reflect all relevant considerations made by those involved in the decision making process. 3. Decision materials should i) clearly describe the problem (through various frames), ii) present various alternative options, and iii) explain the nature and likelihood of their potential positive and negative consequences. 4. Risk information should be both quantitative and qualitative.

Behaviour & culture
focus in decision making

Indicators

B. Behavioural factors

B1 Impeding group
patterns

1. Strain for consensus. What is the level of dissent? Do group members take minority views? Do they maintain these views when facing an opposing majority?
 2. Information-sharing bias. Do group members contribute previously unshared and unique information?
 3. Conflict. Is the group conflict prone? What is the nature of the conflict: task or emotional? Are there group norms about how to deal with conflicts? Is the group confident with respect to solving conflicts?
-

B2 Quality of challenge

1. Structure. Did the group use deliberate process interventions to enhance constructive challenge?
 2. Leadership style. Did the leader create a facilitating climate and encouraged others to participate? Did the leader invite others to speak up? Or did he or she impose his or her preferred solution, while dismissing other's input.
 3. Level of dissent. What is the level of dissent? Do group members take minority point of views? Do they maintain these views when faced with an opposing majority?
 4. Depth of discussion. Did the discussion evolve around a selection of topics, thereby leaving other important information out of consideration? Was the frame of the problem and its potential positive and negative consequences discussed?
-

Role clarity (element A1)

As said, most decisions in financial institutions are taken by groups and teams. A team can be defined as “a distinguishable set of two or more people who interact dynamically, interdependently, and adaptively towards a common and valued goal/objective/mission, who have each been assigned specific roles or functions to perform, and who have a limited life-span of membership” (Mathieu et al., 2000, p.273). Groups are known to perform better if they operate on the basis of a common understanding of the individual roles and responsibilities with respect to the task at hand (Mohammed et al, 2010; Mathieu et al, 2000). Such understanding therefore is crucial to effective decision making.

In accordance with financial regulatory frameworks (BCBS par. 87, EBA article 24.3, IAIS 7.3.9 and EIOPA 1.28). DNB’s supervision assesses to what extent the roles and responsibilities have been clearly defined by the group and subsequently assigned to its individual members. Our inspections have revealed that task allocation within boards and/or between management and supervisory boards with respect to decision making is often unclear and impedes effective decision making. These observations were based on both desk research and staff interviews. Our desk research focuses on written documents – such as board protocols, minutes of relevant meetings and preparatory decision materials – to establish whether the roles had been clearly described, assigned and adhered to. Our interviews with individual staff members test whether the perceptions that group members have of the various roles and tasks correspond with those of their colleagues and whether tasks were performed in accordance with the initial role assignment. Our inspections not only focus on task assignments on group-level. We also assess to what extent other people or functions (such as risk and compliance) were asked to participate in decision making on the basis of a clear mandate. For if their assignments are unclear, it is unlikely that their participation will contribute towards effective decision making.

Meaningful participation of all relevant people and functions (element A2)

The composition of the team is an important prerequisite for good team performance. A team should be composed to include the knowledge, expertise and skills that are necessary for effective decision making (Mathieu et al., 2008; Kozlowski & Ilgen, 2006; Burke et al., 2006; Amason, 1996; Hackman & Morris, 1975). Furthermore, diversity should be acknowledged to allow for different viewpoints and to encourage dissent between group members (Schultz-Hardt et al., 2002). However, diversity can only benefit the group if all individuals actually participate in decision making. And if so, diversity in itself can be a potential threat for group performance and must be managed actively to reduce its negative consequences (Tjosvold, 2008). Our inspections to date have shown that meaningful participation does not come naturally.

DNB assesses to what extent all relevant group members as well as organisational functions (risk & compliance) were involved on time in the decision making process and whether they had the opportunity to actually influence the proceedings by means of debates, meetings and written reports. We also want to know whether their input was actually and sufficiently considered during the decision making process. This can be verified by means of desk research of decision materials, staff interviews and observations of board meetings.

Quality of information (element A3)

Gouran and Hirokawa (1996) point out that relevant information should be made available to or acquired by the members of the group in order to be able to make adequate choices. It enables the group members to get a clear understanding of the problems that must be addressed. Especially in complex or ambiguous situations, there is a specifically urgent requirement for information (Kolbe & Boos, 2009). Not only should this information be sufficient and accurate, it must also be presented so that all group members can understand it, and it should include a summary of various decision alternatives and their consequences. It is also crucial that individual

group members share their particular expertise, which in a diverse group usually is unevenly distributed (see section 5.2 on Complexity).

DNB performs desk research of meeting materials and board books to assess the quality of information. Assessment of such materials enables us to establish whether decisions are taken based on comprehensive and clear information. Assessing these materials also gives us an understanding of the range and depth of information gathering, and we use personal interviews to establish whether individual knowledge was willingly shared. It should be noted, however, that even if information requirements (or the other structural requirements mentioned above) are satisfied effective decisions do not follow automatically. Impeding group behavioural patterns and insufficient challenge may still result in poor decisions.

Impeding group patterns (element B1)

The identification and assessment of group behavioural patterns that may impede effective decision making is pivotal to our supervision. Our risk identification examines if and to what extent such patterns are at work and how these patterns are likely to influence team decision making and the institution's risk profile and financial performance. In the context of decision making, we focus on three impeding group patterns: consensus seeking, information sharing bias, and conflict.

One of the most prominent impediments to effective decision making, is a strong desire for consensus. This prompts people to agree with the majority opinion and to abandon their independent position and perspective. People act on the assumption that the majority must be right or they are afraid of the social costs related to maintaining a minority position (risk of rejection or ridicule by the group) (Janis & Mann, 1977; Nemeth & Nemeth-Brown, 2003). The pressure to conform appears to be heavier in unclear and ambiguous situations, or when group members believe that the group around them is highly competent, credible and has a higher status (Khurana & Pick, 2005).

The second impeding group pattern is known as the information sharing bias. Effective decision making also depends on the level of information sharing among group members during the discussion phase. Research suggests that members of decision making groups inadequately pool their unique knowledge and focus on discussing information that is already known to all members¹¹. This bias creates the risk that decisions are taken based on incomplete or inaccurate information. This can affect the quality of group decision making (Stasser & Stewart, 1992; Stasser & Titus, 1985).

The third impeding group pattern is group conflict, which can be defined as “the process resulting from the tension between team members because of real or perceived differences” (De Dreu & Weingart, 2003, p. 741). Conflict is an inevitable by-product of cooperation (Amason, 1996; Jehn, 1995; Jehn et al, 2008; Mooney et al, 2007; Tjosvold, 2006 and 2008). Conflict may negatively impact team performance, as it interferes with team information processing, distracts attention, increases the cognitive load, limits flexibility and hampers behavioural coordination (Rispens, 2014; Kozlowski et al., 2006; Saveedra et al., 1993). It may also spark negative emotions – such as “jealousy, hatred, anger and frustration” (Jehn et al, 2008, p. 471) – that in turn may hamper rational reasoning as well as mutual trust and respect between group members (Rispens, 2014; Mooney et al, 2007).

Quality of constructive challenge (element B2)

As said, accurate shared mental models are essential to effective decision making (see section 5.2 on constructive challenge). Especially in diverse groups, constructive challenge is the way to create such shared models. Our inspections focus on whether constructive debate takes place, if there are behavioural patterns that impede the debate and which effects this has on decision effectiveness. For example, in our observations of board

¹¹ This phenomenon can be explained by various behavioural causes, such as strong commitment to initial preferences, conformity pressure, consensus seeking tendencies and social and strategic advantages related to information hoarding.

meetings we verify whether all group members participate and feel free to contribute. We also assess whether groups are able to deal with cognitive and other conflicts. Is the board in question able to have intense debates while remaining focused on the task at hand, or do conflicts easily develop into personal and emotional attacks? Or does it cause members to withdraw? These kind of behavioural patterns constitute risks for effective decision making, as they hamper the quality of the debate. In itself, the way a group handles conflict is an indicator of effective decision making. The same goes for the level of dissent. How long is an individual member able to maintain a minority position? Or does the group pressure dissenting individuals into conforming to the consensus position?

The role of the chair in ensuring and encouraging constructive challenge is also important (see for example BCBS, par. 59 and EBA 10.2a and 14.4). During inspections, we aim to establish whether leaders invite others to speak up and whether they focus on full group participation for the purpose of reaching the best possible decisions. In practice, however, we often see directive leadership styles, where leaders strive for adoption of their own preferred solution, while at the same time discouraging debate. This leadership style is likely to increase the likelihood of quick group decisions and is therefore generally known to have adverse effects on the quality of debate and decision making (Baron, 2005; Janis & Mann, 1977; Neck & Moorhead, 1995; Yukl, 2014).

The next section focuses on our inspection findings to demonstrate which observations can be derived from our work on decision making. Section 5.5 focusses on risk mitigation.

5.4 Risk assessment - what do we see?

The following two examples from our inspections illustrate the risks that we encounter with respect to group behavioural patterns in decision making.

The first case study from our supervisory inspections emphasises the need to organise the decision making process adequately, not only with respect to its structural aspects, but also with regard to the behaviour of all of those involved. It concerns a smaller financial institution, part of a larger conglomerate, that been incurring serious losses. Although its investment strategy specifically banned investments in a specific equity class (due to high previous losses), its board nevertheless decided to approve an investment proposal including the banned equities, probably under the assumption this would boost income and profit. The preparation of the decision evidenced several flaws. In spite of the institution's strategic risk profile, the board had failed to involve risk management and compliance officers at an early stage of the debate, which resulted in an incomplete and inaccurate risk analysis (leaving out several major risks and their possible impact). In addition, the consequences of the investment decision were only superficially dealt with. The board approved the investment proposal, and the firm lost a substantial part of its capital as a result. This was an inconsistent and opportunistic decision that did not comply with the institution's chosen strategy.

The decision makers in the example above repeatedly jumped to problem solving rather than gathering more information and discussing the issue in detail. The decision was not challenged in any significant way, also because of the CEO's dominant behaviour in pushing it through and obstructing further questioning and probing. Strangely enough, the entire organisation

appeared to be in the grip of excessive optimism. Perhaps this served as a kind of mental defence against bad news (and probably also because the institution felt sure that its parent company would provide financial support). It displayed an unwarranted sense of comfort that everything would be better this year. The previous year's disastrous performance was neither discussed nor analysed. As a result, the organisation failed to learn from its mistakes. It continued to take ill-prepared and insufficiently challenged decisions. We concluded that these particular decision makers started looking for solutions before getting their facts straight and identifying possible risks, which was attributable to both the lack of a properly organised decision making process and behavioural factors.

A second case study relates to an inspection of a trading department of a large financial institution. The inspection aimed to identify the behavioural patterns that might affect decisions on risk and risk taking. We concluded that in this particular trading department decisions were mainly based on the effects that they would have on the profit & loss account, or were taken on the basis of quantitative risk limits.

Although these are indispensable input factors for effective decision making, predominantly being guided by these 'hard' indicators may result in a lack of professional judgement with respect to individual transactions. It may prevent trading decisions from being based on a comprehensive list of facts, risks and consequences. There was also evidence of insufficient efforts with respect to team learning. As trading decisions were not evaluated afterwards, the group was unable to develop collective norms about risk-taking and subsequently developed no instruments to deal with difficult dilemmas.

These examples demonstrate that ineffective decision making is rooted in a combination of determining factors, relating to deficient processes (e.g. insufficient information gathering and preparation) and ineffective behaviour of the relevant decision makers (e.g. lack of countervailing power). They also make clear that not only management boards, but also other decision making groups and even entire organisations may be subject to the effects of poor decision making. Even more importantly, it makes clear that in many cases, the institutions and the people involved remain unaware of the fact that poor decisions actually affect them. This awareness is especially important if you want to break ingrained patterns that cause organisations and people to make the same mistakes over and over again. DNB has the ambition to act in order to make institutions aware of their behaviour, expect them to change it and take appropriate behavioural and structural measures to embed behavioural change.

5.5 Risk mitigation - what do we expect?

Mitigating the above risks requires a combination of behavioural and structural interventions. Below we will describe the topics that supervisors could address during the mitigation phase (see also our report *Leading by Example*, 2013).

Constructive challenge

DNB believes that improving the level of challenge is a crucial instrument towards enhancing effective group decision making. Team members must be encouraged to openly and constructively debate the validity of facts and assumptions with respect to the decision at hand. To be constructive, challenge should not be personal, but focus on the facts. It should also be inclusive, allowing all decision makers to participate. Only then will financial organisations benefit from a group's diversity in terms of knowledge, experience and diversity of skills. And only then will constructive challenge prevent decisions from being based on incorrect or insufficient

information, or that decisions are taken that overlook important risks (and opportunities).

As said, critical challenge is not without risks. Challenge may lead to personal conflicts and hence impede effective cooperation. Consequently (and because good challenge rarely occurs naturally (Nemeth et al., 2001)), we believe that financial institutions should take measures to make challenge constructive rather than destructive. This requires deliberate interventions at group level. The following behavioural and structural interventions enhance the quality of challenge.

Behavioural interventions

As said, effective leadership is closely related to effective decision making (De Dreu et al., 2008; Janis & Mann, 1977; Lorinkova, 2013). As will be explained in Chapter 6, DNB stresses the importance of promoting a leadership style aimed at ensuring high-quality debate by encouraging all decision makers and key officers to contribute to the decision making process. This type of leadership positively affects the free flow of opinions and perceptions, promotes collaborative decision making and supports information sharing and team work (Lorinkova 2013, p. 537; Neck & Moorhead, 1995). In the end, this leads to more carefully considered decisions, because more alternatives, facts and risks have been taken into account.

DNB's supervision also aims at creating a group norm that tolerates and even expects that different opinions are raised, challenged and discussed. Open norms about task conflict may have a positive effect on the group as a whole in the form of better decisions and intragroup interaction (Jehn et al, 2008; Marks et al, 2001). The same holds true when group members are convinced that they are able to solve conflicts¹². This "resolution efficacy"

¹² In general, one can say that a team's performance is enhanced, when it believes it is able to successfully accomplish a task (Gully et al., 2002).

contributes towards interpersonal communication and trust, thereby enhancing decision making (Jehn et al., 2008). Training decision makers on how to engage in constructive conflict positively affects team performance (Rispen, 2014).

A third important aspect in DNB's behavioural supervision is creating an environment of psychological safety (Burke et al., 2006; Edmondson, 1999). Psychological safety is defined as "the shared belief that the team is safe for interpersonal risk taking" (Edmondson, 1999, p.350). It is a sense of confidence that the team will not embarrass, reject or punish someone for speaking up. This perception stems from mutual respect and trust among team members (Edmondson, 1999). Psychological safety therefore is an enabler of individual team members speaking up and offering contributions to the debate (Bradley et al., 2012; Edmondson, 1999). In addition, trust helps to prevent task conflict from escalating into personal conflict (Simons & Peterson, 2000). Psychological safety can be promoted through positive interactions between group members, especially under situations of stress (Burke et al., 2006, p.1195), and the availability of resources and information (Edmondson, 1999, p.356). Constructive communication also contributes to psychological safety (see Chapter 7).

Structural interventions

In addition to these behavioural interventions, we would like to discuss three important structural interventions. Institutions can enhance the quality of challenge by using dialogue techniques. Such techniques, including the inquiry approach, the devil's advocate approach, and scenario planning, are instrumental to creating a constructive dialogue.

Garvin & Roberto (2013, p.1) emphasise that decision making often goes awry because decision-makers are keen on winning the "battle of wills", rather than exploring the weaknesses of their own position by weighing opposing views (see also Tjosvold, 2006; 2008). They suggest replacing this "advocacy" style of debate by "inquiry", which involves careful consideration

of a “variety of options, working with others to discover the best solution and stimulate creative thinking rather than battling for supremacy and suppressing dissension”(Garvin & Roberto, 2013, p.1). By taking the inquiry-based approach people are engaged in collaborative problem solving that leads to shared ownership of the decision; the participants cooperate in trying to converge their often different perceptions into shared proposals and solutions.

The devil's advocate approach aims at organising critical comments on a decision proposal at hand. Usually the group appoints one or more individuals to provide deliberate dissent. Important for effective use of the devil's advocate approach is that it must be clear to all group members “criticism should not be taken personally, but is part of the organisational decision making process” (Cosier & Schwenk, 1990, p.72). The devil's advocate role should also rotate in order to avoid that certain group members are designated as constant critics (Cosier & Schwenk, 1990; Schwenk, 1990; see also Russo & Schoemaker, 2002 for a similar technique known as “constructive conflict”).

Another method that can be used to enhance constructive challenge is scenario planning. It is defined as “a disciplined method for imagining possible futures” (Schoemaker, 1995). Unlike general conception scenario planning should not to be seen as a spread sheet type prediction of the future, but as an instrument for “challenging current paradigms of thinking” (Chermack et al, 2001, p.8; see also Schoemaker, 1995). By constantly challenging facts and assumptions, scenario planning may contribute to up-to-date perceptions about reality, which may facilitate adaptation to changing circumstances (Van der Heijden, 2011). However, scenario planning is not an easy task. It requires a great deal of time and considerable financial resources and its methods are quite complex (Chermack et al., 2001, p.9). DNB nevertheless believes that well-executed scenario planning creates a shared understanding of the organisation and its context, which is an important feature of effective decision making.

Our supervisory inspections have revealed a growing awareness among financial organisations about the significance of behaviour and culture in general, and decision making in particular. This growing awareness may explain the decisive measures high-risk institutions took following our inspections. Some institutions changed the composition of their boards, while others, following our assessments, strengthened their corporate governance, firmly positioned compliance and risk management in the decision making process, revised their strategy and risk profiles, attended coaching sessions and/or boosted their critical abilities. Our conclusion to date is that in most instances this has resulted in improved decision making and lower risk profiles. The organisations we examined prepared their decisions better, made sure that their key control functions were involved and organised more constructive challenge and debate. On the whole it also led to better information-sharing between the management and supervisory boards (Nuijts, 2013, p.16).

Specific interventions for structured decision making

As explained in section 5.2, DNB's approach to supervision of behaviour is based on scientific research evidencing that a "better [decision making] process leads to a more advantageous result" (Peterson, 1997, p.1107). The structure of the decision making process is an important vehicle for coordinating decision making behaviour and prevent inefficient group interaction and ineffective decision making (Steiner, 1972). Especially for teams that perform critical tasks under time pressure coordination and coordination of behaviour is a critical team process (Lim & Klein, 2006). Our 2013 report entitled *Leading by Example* (2013) therefore urges institutions to strengthen the structure of their decision making processes.

As lack of structure often is an important cause of ineffective decision making, supervisors should address this in the mitigation phase of an inspection. The table below reflects the topics that could be discussed with institutions during supervisory dialogues aimed at enhancing decision making. It also shows the common core of decision activities that scientific

research has identified as crucial to effective decision making. The table should, however, not be seen as a supervisory assessment tool or a set of criteria that each decision making process must comply with. It is intended as an helpful tool for influencing supervisory mitigation dialogue.

Tabel 5.3

Behaviour & culture focus in decision making	Expectations
Constructive challenge (behavioural)	<ul style="list-style-type: none"> ■ leadership style aimed at ensuring high-quality debate by encouraging the contribution of all decision makers and key officers; ■ create group norms implying it is acceptable and appropriate to raise, challenge and discuss different opinions; ■ create an environment of psychological safety
Constructive challenge (structural)	<ul style="list-style-type: none"> ■ use dialogue techniques such as : i) inquiry, ii) devil's advocate approach and iii) scenario planning
Specific interventions for structured decision making	<ul style="list-style-type: none"> ■ for complex situations use a decision making process that distinguishes between the following phases: planning; discussion; decision, and implementation. These phases include the following decision activities; ■ planning: i) organise the process, ii) create a common understanding ("accurate shared mental models") about a) the cause of the problem, b) the roles and responsibilities of the group members, and c) the working environment of the institution (environmental analysis) ■ debate: i) gather and share information, ii) generate alternatives, and iii) ensure constructive challenge; ■ decision: select alternatives; ■ implementation: i) implement the decision, and ii) learn from experience

This supervisory dialogue could for example address whether decision makers have performed the following activities.

- **Planning and coordination:** supervisors should highlight the fact that groups under time pressure often rush into problem-solving without organising their actions first (anti-planning bias). They should emphasise that even in time-urgent circumstances boards should start by framing the problem and clarifying their goals, responsibilities, procedures and most importantly their time constraints (Burke et al, 2006; Forsyth, 2010; Gouran & Hirokawa, 1996; Hackman & Morris, 1975).
- **Mission analysis and environmental monitoring:** this involves discussing the team's mission in the light of changes in the institution's working environment. It enables institutions to adapt their strategy or business models or other courses of action, if necessary. These activities are considered to be an executive's task (Hambrick et al, 2005). The supervisor could urge boards to periodically perform strategic or contextual analyses and make room on board agendas to discuss their outcomes (Lorsch, 2003 and 2012; Palepu, 2012). "Teams that fail to conduct thorough mission analysis will be undermined by changing circumstances or relegated to operating in a purely reactive mode" (Marks et al., 2001, p.365).
- **Problem analysis, information exchange, producing decision alternatives, and the assessment of the negative consequences of such alternatives:** especially the latter activity is crucial to effective decision making (Orlitzky & Hirokawa, 2001). However, this activity cannot be adequately performed without the others. Performed together, these activities should lead to accurate models of what must be done and how this must be done (see section 5.2. on the importance of shared mental models). Supervisors should therefore aim their mitigation efforts at urging institutions to create such understanding.

5.6 Conclusion

On the basis of extensive scientific research as well as our own findings, we are convinced that institutions need a sound and effective decision making process in order to safeguard their future and financial solidity. This does not mean that we believe that an effective decision making process will always lead to successful outcomes. Nor do we suggest that there are simple and “one-size-fits-all”-solutions available. On the contrary, we are very much aware of the complexity of making adequate decisions, but this complexity in itself should be sufficient motivation for all financial organisations to be vigilant about effective decision making.

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Leadership¹

'The greatest leader is not necessarily the one who does the greatest things. He is the one that gets the people to do the greatest things.'

Ronald Reagan

6.1 Introduction

Leadership is one of the most important factors in determining organisational performance. Leaders influence organisational performance directly by making strategic decisions and indirectly through their influence on employees (Hogan & Kaiser, 2005; Hollander, 1992; Lord & Brown, 2004). Seen in this light, leadership is of great interest to supervisors. Firstly, a leader's values and motives impact his² future decision-making. Secondly, leaders communicate their preferences through role modelling, feedback, choices and the use of rewards and sanctions (Schein, 2010). Therefore, the way leaders express their values and motives is an important factor to examine in supervision since it will determine the organisation's culture and culture in turn will affect employees' behaviour and performance (Dragoni, 2005).

In this chapter we elaborate on the relevance of leadership for supervision, the assumptions about leadership that drive our supervision, how we identify risks related to leadership, how we assess those risks and how to influence leadership.

¹ The author highly appreciates the valuable contribution of Ingeborg Rademakers to this chapter.

² Throughout this chapter, we use 'he', 'his', and 'him' referring to male and female leaders for the sake of readability.

6.2 Why leadership is relevant for supervision

Leadership emerges when individuals interact to fulfil a task and are interdependent in doing so. Leaders are either formally designated or they emerge informally. Formal leaders within an organisation include supervisors, managers or executives, while informal leaders do not have a specific formal position within an organisation. In this perspective, leadership is pervasive in the daily organisational context. Moreover, leadership receives a lot of attention in our society and not just in the (financial) business world. Consider politics or sports, for example. As soon as a problem arises or a victory is celebrated, leaders and their leadership are targeted as a reason. Accordingly, leaders are often praised for good results and also often replaced when a crisis emerges.

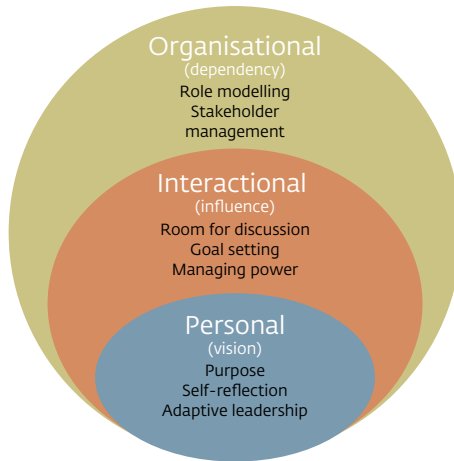
As noted in Chapter 3, an important assumption of our supervision is the focus on leaders. Since formal leaders are responsible for, and are supposed to influence, the institution's performance and outcomes, they are often the primary points of contact for supervision. Top management is in particularly close contact with the supervisors. The CEO, senior management and board are not only the points of contact for most supervisors, but also often the subject of supervision inspections of behaviour and culture. Leaders' perception, reasoning, background, and decision-making have a major impact on the organisational performance (Hambrick & Mason, 1984) and are therefore highly relevant for our work as supervisors. Another reason for supervisory interest in leaders is the notion that leadership influences organisational culture (Schein, 2010): the way leaders act sets an example for the members of the organisation and affects organisational performance (e.g. Hogg, 2010). A leader influences others within the institution through his decisions, by expressing his own values, setting up procedures and establishing structures.

6.3 Assumptions

In its supervisory work, DNB defines leadership as 'the process of influencing others to understand and agree about what needs to be done and how to do it, and the process of facilitating individual and collective efforts to accomplish shared objectives' (Yukl, 2010, p.8). DNB identifies three levels in line with this definition: the personal, the interactional and the organisational level (see Figure 6.1). The personal level refers to the leader's individual beliefs. The interactional level describes the dynamics between followers and a leader. The organisational level is about leadership of the entire institution and leadership in the context of the institution. At each of these levels, assumptions arise that are leading in supervisory assessments of leadership. These assumptions are:

- On the personal level: leadership requires vision to guide activities and others in the desired direction.
- On the interactional level: leadership is about influencing behaviour. Leaders should be able to influence individual employees, teams, departments and organisations.
- On the organisational level: leadership is about dependency; leaders depend on the company's employees to be able to reach their goals. Moreover, leaders and their companies depend on external factors such as markets, regulations, labour, competitors etc. Leaders should be able to manage these dependencies in an effective way.

Figure 6.1: level of analysis and assumption of leadership



Personal level (vision)

As regards the personal level, a strong vision and clear direction are necessary to influence others to move in the desired direction. In our supervision, we examine on a personal level whether leaders have a vision for the company, its business and leadership. We also consider how this vision is expressed and if behaviour such as decision-making is consistent with this vision. Furthermore, we expect leaders to be able to reflect on own behaviour and be able to adjust their behaviour if necessary. Corresponding objectives in supervision:

- purpose
- self-reflection
- adaptive leadership

Interactional level (influence)

On the interactional level, leaders must interact with others to influence them. This interaction is either one-on-one (leader – follower) or one-to-many (e.g. leader – team). Our supervision of this level involves interviewing leaders about their natural style of influence and followers about their perception of the leader. At this level, we assess employees' following behaviour as well. Employees have the ability and the responsibility to influence the leadership process when they experience unsound or destructive leadership. They may feel restricted to act when confronted with a destructive leader (e.g. they may be afraid to be fired). However, we expect that employees try to end destructive leadership, or at least not to support it. Corresponding objectives in supervision are:

- room for discussion
- goal setting
- managing power

Organisational level (dependency)

As regards the organisational level, we differentiate between two dependencies, namely internal and external dependency. Internal dependency is expressed clearly by the notion that a leader without followers is no leader (e.g. Uhl-Bien, Riggio, Lowe, & Carsten, 2014). In companies there is another aspect that highlights this internal dependency, that is if his followers (employees) do not perform well, the leader's performance is therefore also poor. In this sense, a leader depends on his followers and their performance. In addition to internal dependency, there is external dependency. A company operates in a context that includes external stakeholders such as customers, shareholders, and authorities. The task of the company and its leaders is to allow these stakeholders to benefit from the company's performance and existence, or at least to avoid being a detriment. If companies fail to satisfy these stakeholders or do not comply with their norms, they will face losses

and their right to exist will come under threat. Accordingly, leaders and companies depend on the appraisal of these stakeholders. In our supervisory work on behaviour and culture, we examine both the internal and external dependency at the organisational level. Corresponding objectives in supervision:

- role modelling
- stakeholder management

DNB expects financial institutions' leaders to pay attention to the three assumptions at the different levels of leadership and carefully manage these aspects. In the following section, we will elaborate on our supervisory work, including how we identify, assess and mitigate risks connected to leadership. This includes a more detailed discussion of the criteria that were defined for each of the three levels. These criteria are concrete aspects that enable us to assess the three levels and give guidance to organisations and their leaders under our supervision.

6.4 Risk identification

– what are our points of interest?

In order to identify risks related to leadership in financial institutions, we use predefined criteria selected by DNB for its supervision of behaviour and culture. Criteria enable us to categorise and assess the information gathered in our assessments. Note that leadership is a phenomenon that often has been and continues to be the focus of scientific research and theorising. Accordingly, one can list countless criteria that could be interesting for the supervision of leadership. We therefore do not consider these criteria complete, but rather a selection that match our vision on leadership. Moreover, we selected criteria that are particularly relevant in measuring unsound behaviour, risk taking and organisational performance (see Figure 6.1 for the corresponding criteria of leadership at each level).

Personal level (vision)

1 Purpose

A leader needs to create purpose for the organisation: an overarching goal or mission that the company should accomplish is needed to guide an institution in the desired direction. In line with this sense of purpose, the leader should have a vision of his role, of leadership and of behaviour in the company. We expect leaders to have this vision to guide not only their own behaviour but also the company's direction. The vision does not have to be detailed and complex, rather, it should be a point on the horizon for orientation. Additionally, leaders need a vision of how employees' behaviour develops and changes. This is crucial to reach the goals of the leader and the organisation. In our assessments, we often notice a lack of this knowledge.

2 Self-reflection

Self-reflection is an important skill we expect leaders in financial institutions to integrate into their daily work. Self-reflection is a pre-condition for examining the effect of one's behaviour on others. Without self-reflection, leaders are unable to adjust their behaviour and learn from their experience. For leaders to reflect on their actions, the effectiveness of those actions and the impact on others, it is crucial to have time and skills as well as a willingness to learn. A first step in our identification process is determining whether leaders plan and organise efforts at self-reflection. We ask leaders how they perform this type of self-reflection, if they have support and what effects they experience. A second aspect is their attitude: in day-to-day business, managers are often focused on results and 'fixing problems'. Self-reflection is not focused on quick results but on learning lessons and changing one's own behaviour in the long term. In our contact with leaders, we determine, for example, whether they consider what they can learn about the effect of their behaviour on others, instead of solely focusing on jointly solving problems.

When such reflection leads to the conclusion that behaviour has to be adapted, leaders must act accordingly. In our work, we describe this as adaptive leadership. Adaptive leadership is another criterion and is described below.

3 Adaptive leadership

During our inspections, we assess whether leaders in financial institutions are able to adjust their behaviour according to the circumstances. There is no such thing as an absolute state of perfect leadership, which is highly effective regardless of the context. As Yukl (2010) stated: "Aspects of the situation also determine the importance of leadership and what type of leadership is needed" (p.492). Similar viewpoints were mentioned earlier by Fiedler (1964, 1967) in his contingency model and by Hersey and Blanchard (1977) in their Situational Leadership Theory. For example, a participative leadership style (where the leader tries to involve others in decisions) is favourable when strategic vision must be developed and ownership and acceptance of the team are needed. Participative leadership is also helpful when the quality of the decision is highly important and the leader lacks crucial information or problem-solving skills. In such cases, participation will increase quality (Vroom & Yetton, 1973). However, during a crisis or when there is time pressure, a more directive style is needed so directions can be given and decision-making can be rapid (see, for example, Yukl & Van Fleet, 1982). To empower followers and enable them to learn, a leader may not provide solutions to every problem but will allow the followers to come up with a solution. We think it is important that leaders are aware of their natural style, the way they act routinely. A second step is to evaluate whether the natural tendency to act is effective in the specific situation and a third step – if needed – is to adapt one's style to the circumstances.

Interactional level (influence)

In our view, leadership is a process whereby people are influenced in order to reach a certain goal. Moreover, the role of leadership is to address and

solve problems that hinder followers in achieving that goal. Power is the ability to influence others and thus a condition for leadership. Power can be based on such factors as legitimacy (given by the formal position within the organisation), one's expertise and knowledge, or the ability to reward someone (for all power-related factors, see French & Raven, 1959; Raven, 1965; 1992). In our supervision, we examine leadership as an evolving process. This is not restricted to the formal positions and hierarchy within the institution. Accordingly, a leader does not necessarily hold a formal position. We consider who actually has influence within the institution. If this influence differs from the assigned responsibilities, this must be further examined. If people other than the appointed leaders have significant influence, it could be a risk in the sense that the one who is responsible cannot perform his task.

1 Room for discussion

Creating room for discussion is important in generating the right conditions for people to engage in decision-making, to increase employees' commitment to decisions and to enable employees to fulfil their responsibility to reach overall goals.

Room for discussion gives employees the possibility to raise their own ideas, address risks and give input into decision-making processes. Moreover, it is the way leaders enable others to speak about errors, taboos and viewpoints that differ from those of leaders. Room for discussion is linked to organisational performance in the way that groups of people are able to come up with higher-quality decisions. Because of differing perspectives, room for discussion will help anticipate problems and risks connected to the decision. But this effect will only emerge if people feel free to speak up and have the impression that leaders are listening to them (for a more detailed discussion about decision making, see Chapter 5). Another effect of the room for discussion on decision-making involves employees' commitment to the decision (Scott-Ladd, Travaglione, & Marshall, 2006). If employees are able

to take part in the decision making process, the decision will be more readily accepted and employees will feel more committed to it.

We expect leaders in financial institutions to empower employees to think about relevant aspects, raise relevant issues and ideas, and have constructive discussions. Our expectations regarding room for discussion are based on the idea that employees positively influence organisational performance and integrity because they ask critical questions and/or come up with creative ideas. All possible risks related to the issue should be addressed and different perspectives should be taken into account to enable higher quality decisions. However, to achieve this, the process needs to be managed (Tjosvold, 2008; for a more detailed examination of decision making, see Chapter 5). This has to be organised and institutionalised. To ensure this, we expect leaders in financial institutions to invite others to express their viewpoint, to examine these viewpoints and to create scope for discussions, alternative views, mistakes and taboos. In addition, we expect leaders to ensure countervailing power of the second and third lines of defence within the institution (including, for example, risk, finance, and audit). This also raises the subject of group dynamics (for a more detailed examination of group dynamics, see Chapter 8). In groups and between groups there is a formal, visible way of discussing things and a more informal, less visible undercurrent. In the latter, unconscious or subconscious aspects of interaction play a role, such as sympathy or antipathy between group members, conflicts in the group, power issues, inclusion or isolation of group members on the basis of certain characteristics (such as age, experience, dialect, gender, belonging to a certain demographic or professional group etc.). Often, these aspects are hidden under the surface of rational reasoning and discussion. We expect leaders to be aware of the possible effects of these factors and to be able to minimise their detrimental impact on organisational performance.

2 Goal setting

The way leaders interact with and influence followers is a crucial aspect in the supervision of behaviour and culture. Aspects such as fairness are considered important for fostering sound behaviour and minimising risk-taking by employees. Behaviour in organisations depends on contextual factors such as the social or physical environment (Tiggelaar, 2010). Leaders have a significant influence on this environment. For example, setting goals or targets (for the sake of readability, we use 'targets' in the following to refer to targets and goals) is meant to direct the behaviour of an employee. Targets provide clarity concerning leaders' expectations of the employee and thus how to satisfy the leader. Since the leader assesses the employee as part of the performance cycle, this is essential for employees' career and professional growth. Research indicates that challenging and specific targets are related to high employee performance (Locke, Shaw, Saari & Latham, 1981). A target that is too easily reached will result in stagnation while an overly ambitious target will result in undesired and probably unsound behaviour.

We expect an organisational leader to set realistic, challenging and specific targets and incentives to nurture sound employee behaviour. We also expect senior management to pay attention to the way they incentivise employees in reaching these targets. Examples are material incentives (such as remuneration and bonuses) but also incentives in the form of praising or discouraging certain behaviour. The incentives can have a huge impact on the way employees strive to reach certain targets and meet objectives.

We assess whether management is aware of this and evaluates its effectiveness on a regular basis. We also expect leaders to consider how best to engage and commit people to take responsibility and ownership for the common goals, and in doing so, to be aware of the capacities of the group. Leaders must understand the strengths and weaknesses of the individuals and of the group, in order to set feasible targets. This is

important in order to avoid frustration and failure. In our supervisory practice we have seen examples of the latter:

In a financial institution, we observed leaders who created an atmosphere where it was considered inappropriate to seek help if employees were not able to solve problems that arose. People were rewarded for working hard and not asking for help by giving them more work and even higher targets. The result was employees who were burned out and a company that suffered big financial losses. There are public examples of companies where the targets were so high that people were even pushed

Setting feasible targets does not imply a lack of pressure or challenge. On the contrary, we expect an effective leader to seek a good balance between targets that allow people to develop themselves and pure performance targets. Whenever possible, we want a leader in financial institutions to provide opportunities where people (and the leader himself) must step out of their comfort zone, without becoming too stressed. An atmosphere where people can learn and have a 'growth mindset', is more effective for good performance than an atmosphere where people are expected to know everything and work from a 'fixed mindset' (Dweck, 2006). A fixed mindset implies that employees must perform well all the time and want to hear from others how right they are. Among other aspects, this is described as 'the CEO disease' (Byrne, Symonds, & Silver, 1994). A growth mindset implies faith in the ability to grow through learning. People believe that effort is the key to a better performance. They seek challenges and feedback in order to improve. This is difficult in financial institutions, which have a strong focus on control and risk mitigation, while strict deadlines make it difficult to make time for evaluation and reflection. Therefore, it can be very uncomfortable to put people into situations where they might make mistakes. In our supervision, we assess if leaders enable an

atmosphere of 'growth mindset' by asking leaders what type of employees they value most, the 'best' ones or the learners.

3 Managing power

Financial institutions' leaders have a task to fulfil for which they depend on employees. At the same time, they are responsible for the performance and results of the institution as a whole. This dual role of responsibility and dependence implies they have to manage the power they have or use. On the one hand, they should have enough power to influence followers, while on the other hand they should be receptive to how followers influence them. As indicated in research, humility actually benefits the effectiveness of leadership and the engagement of followers especially when the leader is high-ranking (de Sousa, 2014). At the same time, passively managing by exceptions (waiting until problems become severe) has detrimental effects, for example on employees (Skogstad, Einarsen, Torsheim, Aasland, & Hetland, 2007) and therefore negatively impacts organisational performance. In our supervision on financial institutions, we examine the extent to which leaders act, lead and provide structure, as well as the extent to which they empower followers, are receptive to their ideas and back their actions. We expect leaders in financial institutions to deploy all these behaviours in balancing their power and influence. When assessing the underlying dimension, we examine leaders' values ('mindset' in our iceberg model). We expect leaders to be convinced of own values and strength, which, in the extreme, is often referred to as dominance. At the same time, we observe whether there is a certain level of humility.

Organisational level (dependency)

Dependency is a significant aspect in leadership. Leaders depend on others to perform their task and a company's performance depends on contextual factors. In our supervision of behaviour and culture, we differentiate between leaders' internal and external dependency. These dependencies must be managed with care because damaging these relationships can mean (financial) losses for the institution.

Obviously, a leader is not a leader without followers. Accordingly, leaders depend on followers and on their performance. Leaders should enable employees to fulfil their tasks which, combined, form the organisational performance.

1 Role modelling

Leaders are a role model in their organisations (Grojean, Resick, Dickson & Smith, 2004). To provide a moral framework for the entire organisation and its members, leaders in financial institutions must display the highest moral behaviour. The effect of role modelling on employees is rooted in social learning theory (Bandura, 1971). For example, ethical leadership is important for organisational outcomes. Unethical leadership is linked to organisational losses such as the cost of misconduct and the related reputational loss (Karpoff, Lee, & Martin, 2008). This relationship is explained by the fact that ethical leadership is linked to employees' ethical behaviour through their observation of ethical leaders and imitation of their behaviour (Brown, Treviño, & Harrison, 2005). According to the social learning theory, employees learn by observing and imitating behaviour and by incorporating the observed behaviour as a norm. In the supervision of behaviour and culture, we define four elements of role modelling. One is the way leaders express their own integrity and ethical behaviour. A second is the way leaders stand for overarching values and norms and how they integrate these into their daily work. A third aspect is the congruence between the leader's intentions and his actual behaviour. The final aspect is that leaders express organisational goals in their way of acting and communicating. The way leaders in financial institutions act in their capacity of high-status members of the organisation is role modelling, in the sense that it gives their employees an impression of what behaviour is acceptable or favourable within the institution. We assume that senior management in financial institutions is aware of the importance of role modelling and of their own role in setting exemplary behaviour. We want formal and informal leaders in financial institutions to be aware of their position as a role model. And to act accordingly by setting a good

example, giving direction and providing structure to the institution and its divisions, departments, teams, and employees. The aim here is to achieve the organisation's overall goals while avoiding unsound behaviour. For example, if a CEO expresses his concern about sound risk-taking in interactions with the management layer directly under top management, these managers will transfer this concern in their interactions with the next level. Eventually, the concern about sound risk-taking will reach the work floor. This process, which is called 'cascading', will teach employees which behaviours are desirable within the institution.

Furthermore, the congruence between leaders' visible behaviour and their inner values enables employees in financial institutions to define implicit norms they should follow. Inconsistency between leaders' values and their behaviour can have a significant and long-lasting effect. Another reason to focus on role modelling as a supervisor is that mobilising others towards a common goal influences the sense-making processes of organisational members (Hogg, 2001). Sense-making is an information process that helps members of a financial institution to adapt their behaviour to organisational norms and values (Weick, Sutcliffe & Obstfeld, 2005). From this perspective, sense-making "serves as a springboard to action" (Taylor & Van Every, 2000, p.40). Because it helps employees to interpret complex situations, learn from them and act accordingly, sense-making is the beginning of behaviour. Financial institutions should have an effective governance structure, which describes the tasks and responsibilities of different departments and positions within the institution. This formal structure helps ensure employees and members of the organisation act according to organisational strategies and the law. However, whether employees and organisational members actually adhere to the formal governance structures and procedures is not a given. Moreover, one can easily imagine situations in which structures and procedures are not sufficiently clear to guide behaviour. In such situations, the sense-making process will help the individual determine the right behaviour. It is therefore essential that leaders in financial institutions act according

to laws, organisational values and integrity – not only to avoid legal procedures but to influence employees' sense-making of what is right and wrong. Furthermore, when a leader takes ownership or responsibility for a project, it gives followers a sense of the urgency and importance.

In the supervision of behaviour and culture, we examine whether the senior management takes ownership and commitment for aspects such as risk management, compliance, integrity, management/employee development, team effectiveness, culture change and self-reflection. We want to know how committed (executive) management is to aspects and projects related to these issues, how (executive) management expresses this commitment to the rest of the institution, how (executive) management is monitoring these aspects and how they act if the progress of work or projects is at stake.

2 Stakeholder management

Recently, DNB has observed a gap between financial institutions and their stakeholders, such as customers, society and politicians. One example is the discussion about remuneration; in the Netherlands, there is little understanding about one another's viewpoints. Furthermore, in scientific debate and research the morality of leaders is given more and more attention (e.g. Demirtas, 2015; Mehta, 2003; Padilla et al., 2007).

As supervisors, we think a lack of mutual understanding poses a reputational risk for financial institutions. Accordingly, we are currently developing a vision, framework, and methods to assess this issue. Below, we elaborate on our thoughts about stakeholder management.

Regarding the external dependency of leaders and their institutions, financial institution's leaders need to actively manage the interests of external stakeholders. The survival of firms is linked to the influence of stakeholders (Harting, Harmeling, & Venkataraman, 2006; Hillman & Klein, 2001). Ignoring others' interests is among the aspects that make up 'destructive leadership' (Shaw, Erickson, & Harvey, 2011). As such, leaders in the financial sector should not only exhibit sound behaviour but ensure

institutional behaviour that is beneficial – or at least not detrimental – to stakeholders. Managing this dependency is not only a moral obligation for leaders but a necessary type of risk management and a way to ensure sustainable organisational existence. Research shows a positive relationship between stakeholder management and firms' long-term performance (e.g., Cragg, 2002; Rowley & Berman, 2000). For example, a high-quality relationship with authorities can help organisations gain the support of these authorities when they want to extend or improve their infrastructure. Some people tend to designate stakeholder management by organisations as a cost. We prefer to see it as a form of risk management. DNB is currently further developing the assessment methodology to explicitly assess a leader's awareness of stakeholder dependency and how he can best fulfil the task of managing this. In doing so, we will not have absolute standards about what behaviour is considered responsible and what is not. Instead, we will examine how leaders in financial institutions become familiar with stakeholders' interests and points of views, and how they incorporate these into their leadership, vision and decision-making processes.

For an overview of all indicators in the three levels and the methods to examine them, see Table 6.1.

Table 6.1: Indicators and assessment methods for leadership

Behaviour & culture focus in leadership	Indicators
Personal level: Vision	<ul style="list-style-type: none"> ■ (follower's perception of) vision of the institution ■ (follower's perception of) vision of leadership ■ vision of own role and task ■ self-reflection (presence, skill and attitude) ■ adaptive capacity
Interactional level: Influence	<ul style="list-style-type: none"> ■ followers are convinced to follow the leader ■ balance between leader's and follower's action and power ■ followers experience a constructive climate
Organisational level: Dependency	<ul style="list-style-type: none"> ■ leader's sound and ethical behaviour (and follower's perception thereof) ■ stakeholder's (interests) are involved in leader's decision-making processes ■ Marketing and external communication is transparent, honest and aligned with stakeholders' interests and perceptions

6.5 Risk assessment – what do we see?

In this section, we will outline what types of leadership we actually see in our supervisory work and how this relates to risks concerning organisational performance and unsound behaviour. We will use examples to describe our observations. Please note that this is just a selection and not meant to be comprehensive. Our intention is to give an impression of the supervisory practice.

Personal level (vision)

On the personal level, two points of interest often arise in our supervisory work in the financial sector. One relates to the vision of leaders on leading people and one concerns leaders' self-reflection abilities. Regarding vision, leaders in financial institutions we speak to often have a direction in mind for the institution. However, what is often lacking is vision on how to stimulate their employees to get there. As we outlined earlier, leadership is about influencing people and leaders should therefore have a vision on how to do that. Note that this is not about the skill to influence people but the basic assumptions concerning how employees act and why. Some leaders pay a lot of attention to the technical aspects but not the human aspects. This is illustrated by a leader who answered our question about how he wants to achieve the targeted results with 'this is what has to happen and, therefore, what everybody will do.' This answer oversimplifies the knowledge and vision of how people change their behaviour. This lack of awareness of the complexity of behavioural change decreases the leader's effect. This is a risk because the necessary goals of the leader and the institution have to be reached in order to ensure the institution's sustainable performance.

A second main aspect we see in our assessments concerns the self-reflective behaviour and attitude of leaders in financial institutions. In interviews with leaders, we have noticed a lack of time, skill and/or willingness to reflect on their own behaviour. When it comes to time, leaders often have other priorities than self-reflection. For example,

one management board had planned an annual session to reflect on their behaviour. However, circumstances meant they did not reflect at all but instead discussed other issues that were – in their eyes – more important. As a result, the board did no self-reflection for almost two years. Obviously, this can have risks regarding board members' blind spots. After all, self-reflection can help pinpoint one's own part in problems, which enables leaders to solve these problems. Without reflection, issues can persist and even escalate. When it comes to skills, we often see leaders reflecting on technical issues or the content of decisions rather than personal or process aspects. These issues are about what they personally could do differently in future. And regarding attitude, we see that leaders often lack a learning perspective on their own behaviour. In their attitude, leaders often search for a fast solution to the problem instead of trying to learn from problems and find solutions that will work for the long term.

Interactional level (influence)

In our supervision, we examine how leaders empower followers, asking for ideas and providing opportunities to voice their opinions. For the leader, this is a matter of finding an adequate balance between dominance and humility. How difficult this can be is illustrated by the following example:

The top management of a financial institution was very good at stating messages but not at listening to responses from lower management and employees. When we voiced this observation, top management refuted our criticism and started to complain. When we returned a couple of weeks later to discuss the follow-up of our assessment with a larger group of people, the top management finally mentioned their difficulties in listening to others in front of the group. More over, they asked the group to help them by giving more feedback on this issue. This enabled a more open, two-sided communication between the top and lower management, and made it easier to discuss behaviour in a constructive way.

In this example, the top management's intention was probably good in that they wanted feedback and others' points of view. However, they seem to have such a strong pattern of reacting defensively and holding to their own viewpoints that the first reaction to our criticism was denial. Recognising their difficulty in front of a large group sent a powerful message, namely that they want to change and are asking for help. Without this change of attitude, the atmosphere of little discussion and interchanging viewpoints, ideas and concerns would have remained. On the interactional level, we explicitly look for destructive leadership. Destructive leadership is behaviour that is negatively associated with employees' well-being and performance and positively associated with turnover intention, resistance towards the leader and counterproductive behaviour (Schyns & Schilling, 2013). This means that we not only expect leaders to show constructive leadership to increase performance, but also not to show destructive leadership, which is a specific type of leadership, rather than the absence of constructive leadership (Shaw et al., 2011). In this vein, we also assess whether the followers act constructively. We expect followers to not conform to destructive leaders or participate in the destructive intentions of their leader. Leadership is a process between two individuals, and therefore employees (followers) can influence their leaders' behaviour. We expect board members (or employees) to act accordingly when their CEO (or manager) is destructive (Uhl-Bien et al., 2014).

Organisational level (dependency)

Role modelling of leaders within their organisation is of great importance because it can influence employees' sense-making, and thus their behaviour, to a large extent. In the following example, the sense-making process of employees in a financial institution was influenced in the long term by a single action on the part of their leader.

A top manager of a financial institution wanted to create more empowerment and engagement at the employee level. He organised town hall meetings to express the importance of asking questions. At one point in the presentation, an employee raised his hand and asked a question. The immediate response of the top manager was: “what a stupid question!”. This anecdote was told for years within the institution, reflecting the organisation's punitive culture. As a consequence, employees did not feel encouraged to engage more in discussions with the management. The top manager's behaviour obviously did not contribute to his ambition of empowering employees. Instead, it hindered it.

As outlined in this example, the manager's behaviour was incongruent with his intention to empower employees. This led employees to doubt the manager's real intentions and his reliability. Moreover, this example influenced the employees' interpretation of leaders' intentions beyond this particular manager; it harmed their trust in the institution's management as a whole, which continued for some years. Obviously, the relationship between management and employees was not effective.

We expect leaders to influence the climate in teams, departments and the organisation in order to prevent counterproductive and unsound behaviour of employees. We expect leaders to do this directly by giving the good example and indirectly by enabling a constructive climate. This climate should enable a sound mindset, open communication (see chapter 7) and constructive conflict (see chapter 5).

6.6 Risk mitigation - what do we expect?

To change leadership behaviour, supervisors need to be aware of different ways to intervene. However, a change in leadership – just like a change in any behaviour – takes a lot of time and effort. In our supervisory interventions in financial institutions, we work according to cognitive and behavioural learning theories (e.g. Derry, 1996). These theories assume that actual behaviour is rooted in assumptions and cognitive schemas about the social environment and organisational effectiveness ('mindset', in our iceberg model) and its interaction with the specific situation or context (Tiggelaar, 2010). According to this theory, and as explained in more detail in Chapter 4 in this handbook, influencing behaviour and culture is directed towards the three levels in the iceberg model. In this section, we elaborate more specifically on mitigation strategies for leadership.

In the context of leadership, we start creating self-awareness of own behaviour through challenging dialogue. In our experience, the dialogue with a leader is, in itself, an intervention. This is also reflected by our emphasis on self-reflection in leadership (see the section about self-reflection in this chapter). Accordingly, we ask leaders and financial institutions to actively work on self-reflection and awareness. For example, we expect financial institutions to select candidates who have this competence, to incorporate it into the HR instruments, such as succession planning, and to pay specific attention to self-awareness in meetings. More specifically, we stress that leaders must create some scope for reflection (about their own behaviour) in order to define their effects on followers and the organisation. Ideally, self-reflection is integrated into the leader's daily functioning. In that case, self-reflection not only occurs during the planned moments, but constantly. One way to reflect on the development of the senior management team is 'self-evaluation'; in the Netherlands this is mandatory. Self-evaluation is a session during which a team (such as a board of directors) reflects on its behaviour as a unit. This reflection is primarily about the way they work together. Self-evaluation

with an external facilitator may increase its effect. Such a facilitator is experienced in finding safe ways to discuss sensitive topics in the team (see also Chapter 8 about group dynamics for processes in groups and teams). To sum up, as a first intervention, we expect leaders in financial institutions to organise and perform self-reflection, to be able to point out what they have learned and how they implement self-reflection in their daily work.

A second intervention in leadership is about making sure the leader is able to adjust his own behaviour according to the first step (self-reflection). To ensure this, we intervene on a systemic level by asking leaders to listen to feedback from others concerning whether their behaviour has changed. Moreover, we encourage others to adjust their behaviour to enable different behaviour from the leader and encourage them to give feedback to the leader. This intervention is directed towards the level of group dynamics in the iceberg model.

A third intervention is directed towards the level of mindset in the iceberg model. Making changes on that level is tough, but we try to address our concerns about risks related to this level to the leader and the direct environment, such as the board of supervisors. If these interventions do not have the intended effect, we – as supervisors – are permitted to replace (executive) management, however this is an extreme intervention. Additionally, solely replacing (executive) management may not always be sufficient to enable change within an institution. Accordingly, DNB only takes this step in severe situations and as a last resort. In our supervision of behaviour and culture we primarily intervene on a systemic level to achieve sustainable change in financial institutions. We assume a leader is, in principle, capable of fulfilling his task. Leaders in financial institutions have undergone DNB's fit and proper test concerning their suitability and reliability before starting at the (executive) management level (for differences between supervision of behaviour and culture, and fit and proper testing, see Box 1 and Table 2). Still, our assessments can reveal risks and detrimental effects on organisational functioning in the (social)

context of the institution. Such risks are a concern of the social system (for instance, a team or board) and not solely of the particular leader. Accordingly, replacing a leader may be not a solution if the social system itself carries risks. Consider, for example, a CEO who is very dominant in board meetings and does not listen to others' ideas and opinions. We see this problem as multifaceted in that other board members do not intervene but somehow accept the leader's behaviour and enable his dominance. In our intervention, we would address the risk of an overly dominant leader to the board of directors as a whole instead of solely to the CEO. The leader (CEO) should be aware of his propensity to dominate a discussion and should restrain himself. On the other hand, board members should persist in giving their own opinions until they ensure the CEO has listened.

Box: 1 Supervision of behaviour and culture vs. fit and proper testing

Fit and proper testing

Regarding the supervision of behaviour and culture, we often receive questions about the difference and relationship between supervision of behaviour and culture, and fit and proper testing. First of all, both are supervisory tasks performed by DNB and are therefore related. If needed or requested, the two expert centres share information. However, the information that is shared is primarily intended to provide the supervisor with context for the assessment or testing. The two types of supervision differ on several aspects (see Table 6.2). For more information about DNB's fit and proper testing see also: <http://www.toezicht.dnb.nl/4/2/16/50-229347.jsp>

Table 6.2: differences between supervision of behaviour and culture, and fit and proper testing

Supervisory aspect	Behaviour & culture supervision	Fit and proper testing
Goals	Judgment about risks related to the behaviour and culture of an institution.	Judgment about the capacity, integrity and suitability of an individual executive.
Result	Risks concerning behaviour and culture.	The decision about whether or not a candidate can assume his position.
Level of assessment	(Part of) an institution	Individual candidate
Leadership	In the context of the institution. How is leadership defined by leaders?	An individual competency. Profile is based on input from the institution and supervisor.

A special remark is in order concerning the role of the financial institution's internal supervision (such as the board of supervisors) when it comes to mitigating risks connected to leadership. We assume internal supervision has a significant influence (for a discussion of this issue, see Chapter 12). Therefore, in mitigating risks for leadership we intervene in the board of supervisors as well. In the same vein, we try to minimise our role in implementing actual new behaviour (see Chapter 4 about methodology). However, we often conduct follow-up meetings or follow-up inspections to ensure the risks addressed in our previous assessments have been mitigated. During these follow-up assessments and meetings, we examine two aspects. The first is whether the institution made an effort to mitigate the risks. This is about actions, plans and changes to the structure that should help the mitigation process. The second aspect is about the actual

effect of the effort. Obviously, the second aspect is the most important one. However, an institution may have put in a lot of effort but not yet seen the effects. A deeper examination of why the effort did not have the desired effect may be important for the institution.

In Table 6.3 we summarise our expectations of leadership in financial institutions.

6.7 Conclusion

In this chapter we elaborated on why and how leadership in financial institutions is assessed in the supervision of behaviour and culture. We stressed the relevance of leadership for organisational performance as well as for sound employee behaviour and the financial institution as a whole. At the same time, we acknowledged the dependency of leaders on employees and external factors. In view of this, we also emphasised that we do not prescribe a certain leadership style for financial institutions. Instead, we described important elements of leadership we consider in our supervision.

Table 6.3: supervisory expectations

Behaviour & culture focus in leadership	Expectations
Vision	<ul style="list-style-type: none"> ■ Leaders have a vision of where the organisation needs to go. ■ Leaders express their vision in a comprehensive and consistent way. This is needed in order to give employees an understanding of what is expected of them and to ensure they can commit to the vision and goals. ■ Leaders reflect on how they are acting and if this is in line with the law, organisational values and organisational goals. ■ Reflecting on own behaviour enables adjustment of this behaviour. Furthermore, if senior management reflects on its behaviour, this highlights the importance of doing so to all organisational members.
Influence	<ul style="list-style-type: none"> ■ Inviting others to express their point of view by asking them to join the meeting, asking questions and offering compliments for divert discussion or given opinions. ■ Facilitating meetings in order to give everyone the possibility of presenting their ideas and enabling a constructive discussion in which the different concerns, risks and alternatives are openly considered. ■ Leaders facilitate followers in reaching their goals and ensure they are able to take their responsibility. ■ Leaders are dependent on followers in achieving organisational goals and a high performance. Only a mixture of guidance and facilitation can ensure individual contributions to organisational goals.
Dependency	<ul style="list-style-type: none"> ■ Showing commitment to organisational goals. ■ Being a role model in their behaviour at any moment. ■ Acting congruently with the vision and goals.

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Communication

7.1 Introduction

Recently, a financial institution was in the news due to the departure of an executive officer after internal bickering. During meetings, he continually checked his phone and updated emails while colleagues were speaking. He completely ignored what was being said and instead fiddled with his files and papers. This was of course particularly disruptive to a constructive dialogue in the boardroom and it was clear that there was no longer any sense of interconnectedness or mutual respect. There was an absence of drive and commitment to communicate effectively in order to lead the dialogue towards a desired outcome that would serve the board and the organisation as a whole. Unfortunately, this is not an isolated example. The media regularly report the resignation of top executives following internal squabbling with board members or poor communication with internal supervisors. The immediate cause is often an alleged difference of opinion at a strategic or tactical level. But the question is whether this is really the essence of what happened behind closed doors. After all, more often than not differences of opinion can be bridged.

Supervision of behaviour and culture attaches particular importance to communication because it directly influences the effectiveness of groups which, in turn, impacts the organisation's performance. Literature studies support this stance (Greer, Caruso & Jehn, 2011; Losada & Heaphy, 2004; Jehn & Mannix, 2001; Orlitzky & Hirokawa, 2001). Given that the financial sector has been facing complex challenges and will probably continue to do so in the near future, we can expect that the value and impact of

communication will further increase. In order to regain the confidence and credibility of the various stakeholders of financial institutions, top level executives must demonstrate how they are working to improve their board effectiveness. They need to be transparent about which performance objectives they are putting into place and the beneficial effects they are achieving. Communication forms an inseparable part of this. For the coming years, DNB's objective is to encourage boards and management teams to the effect that they can recognise and acknowledge their own communication patterns and are willing and able to make the necessary adjustments. A better understanding and awareness of this topic should largely prevent the development of longstanding ineffective communication.

Overview

The core of this chapter addresses how communication is taken into account during the supervision cycle of risk identification, risk assessment and risk mitigation when DNB performs inspections. This chapter is structured as follows: section 7.3 starts with an explanation of what DNB considers important when observing communication and how supervisors identify relevant communication. Section 7.4 focuses on what DNB actually observes in the financial sector and the risks these observations entail. Section 7.5 sets out what financial institutions can do to improve their communication and how supervisors can help, bearing in mind that improving communication also plays a pivotal role in enhancing group performance. For the sake of clarity, section 7.2 starts with a definition of communication and what is generally considered to be effective communication. It also explains how effective communication is linked to (group) performance and which indicators are relevant in forming an opinion on the degree of effectiveness in communication.

7.2 Communication

A wide variety of studies show that communication is a crossroads where different disciplines come together. Different fields like ethology (the science of animal behaviour), cybernetics and systems approach, psychoanalysis and linguistics deal with this subject in such a diverse way that it is hard to believe these studies cover the same aspect of social reality (Amado & Guittet, 1975; Remmerswaal, 1995/2013). Consequently, there is not just one definition, model or theory on communication (Barnlund, 2008; Shannon & Weaver, 1949). This is also one of the reasons why several researchers and academics (Craig, 1999) have proposed a vision for a communication theory in an attempt to unify this rather disparate field and address its complexities. Communication is defined here as the direct or indirect exchange of information between people who are aware of each other's presence. The information is provided, received and interpreted both consciously and unconsciously. So communication can be verbal and non-verbal, used to transfer information and as a means of interaction by which parties are mutually influenced (Bauer, 1964; Oomkes & Garner, 1987/2011; Watzlawick, Beavin & Jackson, 1967).

Communication is effective if the recipient interprets the message sent in the same way as the sender. Effective communication serves the purpose for which it was planned or designed. Such purposes may include eliciting change, generating action, creating understanding, informing or communicating a certain idea or point of view.

Since communication is an expression of underlying group dynamics, it is considered a strong indicator of the group climate. Research shows that a supportive group climate generates positivity or positive emotions. These positive emotions create emotional spaces, generating open possibilities for action and broadening action repertoires. In addition, positive emotions strengthen connectivity in the group and build durable physical, intellectual, and social resources (Frederickson, 1986). High-performing teams for

example, show a balance between inquiry and advocacy, between questions and answers, thus allowing a productive and ongoing dialogue while communicating. Moreover, there is a positive correlation between the role of positivity and connectivity in the performance of business teams, and the team capacity to deal with increasingly complex environments such as the financial sector is currently facing (Stacey, 1996).

Other research (Jehn & Mannix, 2001) shows that the way group members deal with conflict – which is also an expression of the communication climate – directly impacts group performance. Assuming that there is always some sort of conflict in teams, it is relevant to consider how much and when, rather than if, conflict occurs. And subsequently to address how to deal with this using communication as a way to steer the group in the desired direction. In order to develop high-performing groups, managers must encourage open discussion norms, high levels of respect among team members, and a cohesive and supportive team environment. In addition, the conflict training that managers or leaders conduct should be done at the early stages of group formation. The results of our inspections suggest that group processes at the early developmental stages influence performance throughout the entire group life. Managers play a key role in setting open communication norms and a cohesive and friendly environment that enhances both members' attitudes and a group's overall performance. Teams will also be more successful to the extent that their leaders can promote constructive debate concerning the task goals or outcomes at hand, especially at the midpoint of the interaction. At the same time, the potential for relationship conflict – related to personal clashes over topics such as values or personality – and process conflict – related to the logistics of task accomplishment – should be minimised during interactions (Greer & Caruso & Jehn, 2011; Jehn, 1997; Jehn & Bendersky, 2003).

Research shows that there are three important indicators that determine the effectiveness of communication. The first one is communication

climate. This says something about the degree of openness or closeness in communication. Interpersonal relationships, disclosure of personal information and disclosure of feelings are important elements determining the communication climate. The second indicator focuses on the different communication levels in conversations. This indicator discloses how well participants in a conversation are able to distinguish and shift from content to relationship aspects in communication. The third indicator gives insight into the communication structures in groups. These structures – also known as communication patterns – can be traced by tracking interaction frequencies between group members and observing the roles group members take on during meetings.

7.3 Risk identification – what are our points of interest?

This section discusses how the communication climate, communication levels and communication patterns are identified during an examination and the methods used to form a picture of these indicators.

Communication climate

As said, communication climate is the first indicator and the way people communicate is a good indicator of the group climate. More specifically, the focus is on elements that enhance or block a supportive climate. The degree of openness or closeness in communication is especially important, as there is a correlation between the role of positivity and connectivity in the performance of business teams. One of the main guidelines for making communication effective and meaningful is to develop a communication climate of mutual trust.

Again, the first element focuses on the nature of interpersonal relationships. Research (Gibb, 1961) shows that fundamental improvements in communication can be made by making changes in interpersonal

relationships. Consequently, DNB observes whether the nature of the relationships leans towards being more constructive, thus contributing to the communication climate, or more defensive, thus inhibiting effective communication. Important building blocks to make cohesive and supportive groups are teamwork, give and take, friendly competition, flexibility and identity. Asking open and neutral questions is another way to support effective and meaningful communication and is therefore also very important when observing board meetings. Characteristics that enhance defensive climates are evaluation in the sense of blaming, finding fault and 'why' questions. Control with the aim of manipulating others to do your work is also detrimental to a supportive climate. And strategizing, with the intention of withholding information or using cautious wording, also inhibits effective communication. The same applies to indifferent communication or an impersonal 'whatever' attitude. A sense of superiority, leading to cliques or coalitions, and certainty, resulting in dogmatism and fixation on a certain way, also inhibits effective communication. Clearly, behaviour that induces or increases defensiveness negatively affects communication.

The second element focuses on the degree to which group members disclose personal information. The frequency and level of openness group members show in bringing forward their own attitude, their values, convictions and personal experiences are important measuring points. The more group members share personal information, the more open the group climate (Remmerswaal 1995, 2013). However, the frequency and level of openness can be influenced by all kinds of circumstances. Often (unspoken) hierarchical aspects and the size of the group play a dominant role. When these influences are not taken into account, communication may become closed and defensive, adversely affecting the communication climate. For example, sharing personal information is influenced by the team members' perceptions of the power they hold within a team and the alignment with others' perceptions of their power (Fast, Gruenfeld, Sivanathan & Galinski, 2009; Greer & Caruso & Jehn, 2011).

And it is also relevant to notice how personal information influences subsequent communication in the group. For example, when group members have a similar work ethic, they tend to agree on norms regarding their work, and this agreement in turn promotes harmony (Nemeth & Staw, 1989) and decreases interpersonal tension (Schneider, 1983). These conditions allow team members to open up and share personal information. In contrast, when members' core values and beliefs about their daily work differ, friction and emotional upset may occur (Bar-Tal, 1989; Schein, 1986), leading group members to be reluctant to share personal information.

The third element focuses on the degree to which group members disclose their feelings in the sense that the group uses these feelings as valuable information to learn from and improve functioning. These feelings are actually an expression of a person's mind set. This mind set reveals what is really important to the group member in question as regards values or beliefs on matters of trust and integrity, for example. It is essential to note that each person perceives information or communication differently, which impacts the position a group member takes in a discussion. These perceptions and positions are influenced by the individual's life history, upbringing, education, the current context and so forth. This is why we may expect different perceptions and feelings to emerge depending on the topics discussed. And thus it seems logical for group members to be aware of the life history and former context each one brings to the group. When group members take these backgrounds into account, understanding and empathy is enhanced, and unnecessary misunderstandings and conflicts can be avoided. As stated previously, understanding and empathy strengthen a supportive group climate, leading to strong connectivity in the group, which enables high team performance (Losada & Heaphy, 2004). In other words, a better mutual understanding and a strong connectivity lead to enhanced group performance. This is because group members develop mutual respect for each other and personal clashes over topics like values and personality, and even process conflicts regarding the logistics of

task accomplishment, are largely reduced (Jehn & Mannix, 2001). Investing in emotional expression has also been proven to be foundational for the pursuit of long-term virtuousness for individuals and teams. It enables individuals and teams to recover quickly from difficulties, thus allowing them to adapt and grow (Stephens, Heaphy, Carmeli, Spreitzer & Dutton, 2013).

Communication levels

The effectiveness of communication is also highly influenced by communication levels, the second important indicator in the supervision of behaviour and culture. A central assumption is that people communicate simultaneously on multiple levels. Watzlawick et al. (1967) state that each communication has content and a relationship aspect. In other words, communication includes more information than just the plain meaning of words. This information concerns how the speaker wants to be understood and how he perceives his relation to the receiver of information. The aspect covers how the message is expressed non-verbally. This relational aspect of interaction is known as meta-communication and is the most important element in communication. Non-verbal communication can be expressed through eye movement (for example, winking, squinting, frowning), use of voice (such as emphasising certain words to reinforce specific parts of the message), posture (for instance, playing 'big' when attacked verbally, or arms crossed to make no contact or head between both hands to show despair) and micro-expression (involuntary facial expressions such as sadness, anger, fear, disdain or happiness). Content refers to what is said verbally. In order for the information to be understood, the message needs to be clear, simple and honest while the timing of the message is also important. Therefore, the content also relates to the quality of the information given. The communication style should be taken into consideration as well: it is important that the sender uses a communication style that relates to the content of the messages being sent. Otherwise misinterpretation and, consequently, miscommunication come into play.

Being able to interpret both levels, in terms of content and relationship aspects, is essential in understanding and communicating (Cozijnsen, 2012).

Communication patterns

The third indicator we observe involves the communication structures or communication patterns a group develops. The easiest way to trace these is to keep track of the interaction frequencies between group members. For example, who speaks the most, who is being asked for input and how this input is valued and taken into account with regard to the final decision being made. Some group members frequently express opinions, while others often ask questions or disagree with opinions given. This information provides us insight into:

- the distribution of power – for example, who has the most impact on decisions being made? Is it the formal leader or is there an informal leader?
- the differences in status – for example, is the opinion or position of a less experienced group member considered less important? Are there differences in time and opportunity for a group member to actually respond?
- the coalitions and subgroups – for example, are there any coalitions or subgroups that communicate more often with each other than with the others, and does this impede communication in the group?
- the task or social focus – for example, is the nature of the communication mainly task-focused, such as requiring suggestions, opinions and information? Or is the nature of the communication focused on social-emotional responses, such as appreciation, agree/disagree, tension or disapproval (see Bales, 1950)?

Combining this information gives us insight into whether communication is effective or not and how that influences group dynamics.

Additional information on communication patterns can be derived from observing the roles group members take during meetings. There is a broad range of methods (Bales, 1950; Kantor, 2012) that can be used to analyse these roles. DNB's focus is on the common denominator of these methods, namely:

- **Problem-solving.** Is there a balance between participants focusing on active problem-solving while others reactions are more reflective? How is this continuous feedback on the proposed solutions taken into account? And to what extent are the outcomes acceptable to the group?
- **Feedback and reflective learning.** What is the ratio between positive and negative feedback? To what degree does the group have a common situation definition and the ability to come to potential solutions that match the group's goals?
- **Individual roles and preferences.** To what extent do we see group members initiating and providing direction? Which members give support and help with completion? Who challenges and provides correction and who observes and provides perspective? Observing communication in board meetings shows that communication is effective when individuals move fluidly among different roles or so-called action stances, making full use of the interaction space.

DNB uses several methods to identify risks concerning communication. As described in Chapter 4 of this handbook, these methods are self-assessments, interviews, employee surveys and board observations. In short, the communication climate, communication levels and communication patterns are important indicators we use to form an opinion on the effectiveness of communication. In order to gain insight we use different methods that help us to both perceive and observe communication. See Table 7.1 for a short overview.

Table 7.1: Indicators for assessing communication

Behaviour & culture focus in communication	Indicators
Communication Climate	Interpersonal relationships <ul style="list-style-type: none"> - teamwork - give and take - friendly competition - flexibility and identity asking open and neutral questions Disclosure of personal information <ul style="list-style-type: none"> - how often do group members express their own attitude, their values, convictions and personal experiences? - how do other group members react to and perceive the information? Disclosure of feelings <ul style="list-style-type: none"> - how often do group members speak up on how they feel in order to learn and improve functioning? - to what extent do group members take into account the context and life history of the person communicating?
Communication Level	Interpret content and relational level of communication
Communication Patterns	Frequency of interaction <ul style="list-style-type: none"> - keep track of the interaction frequencies between group members Roles in interaction <ul style="list-style-type: none"> - problem solving - feedback and reflective learning Individual roles and preferences

7.4 Risk assessment – what do we see?

Risk assessment of the supervision cycle focuses on what DNB actually sees during inspections and the risks these observations may entail. In order to enhance the readability of this chapter, the sequence of the indicators as mentioned in the previous section is maintained when giving examples and associated risks. Note that these examples are not exhaustive and are only used to illustrate the communication climate, communication levels and structures. However, before giving examples of each indicator, we often observe that when it comes to topics that affect group members on an emotional and reputational level, actually raising existential questions, this forces groups to pay explicit attention and channel energy to mutual communication. With so much at stake, groups obviously explore all interests concerned and aim at fully understanding the respective individual perspectives. In this respect, the most complex cases particularly seem to lead to developing best practices, albeit unintentionally.

Communication climate

As said, one of the main guidelines for enhancing the effectiveness and significance of communication is to develop a supportive communication climate based on mutual trust. And again, fundamental improvements in communication can be made by making changes in interpersonal relationships. These can be observed between the various committees in boards – formal subgroups – and boards as a whole.

In recent inspections we observed that in the aftermath of the financial crisis boards are paying a great deal of attention to finance and risk. Most boards have set up committees with in-depth knowledge of these topics. Based on our observations, these committees have complex substantive discussions. This has led to an inherent dependency between non-expert and expert board members concerning finance and risk.

DNB wants to understand how this inherent dependency affects the communication climate: what are the effects of the emergence of a non-expert and expert fault line? For instance, in some boards these committees invest a lot of time in sharing information and catching up with the non-experts so that the latter are able to challenge, learn and actually decide on the finance and risk issues at hand. In those cases, a positive development in the cohesion of the group can be observed, facilitated by a supportive communication climate. Board members – both experts and non-experts – show mutual respect in their communication by asking open questions, showing empathy and equality by exploring different perspectives and articulating in terms of 'we', 'us' or 'our'.

The flip side is also present. In those cases, the fault line creates differences in status between board members who are part of the Finance & Risk committee versus those who are not. These status differences become visible in communication: experts respond irritably to questions from non-experts. In those cases, a greater distance between individuals can be observed, leading to less group cohesiveness. This has the negative consequence that non-experts become reluctant to ask simple yet fundamental questions. Another aspect is that individuals start to think in 'we' and 'them' terms and a communication climate develops where critical challenge and constructive dialogue are virtually absent. This inhibits critical dialogue and does not facilitate the free expression and discussion of dissenting views, different alternatives, perspectives on risks and outcomes in the decision-making process. Not only does this affect the communication climate, but it also leads to risks in terms of ineffective group dynamics and a poor quality of decision-making.

A second element that influences the communication climate is the disclosure of personal information. As said, the most important elements that influence sharing of personal information are linked to the size and hierarchical aspects of the group. The size of the group is most relevant at pension funds. The number of board members may be significant and, since

there is less cohesion and connectivity in larger groups, this can be an extra hurdle to sharing personal information. The associated risks may ultimately prevent all group members from fully participating and airing their views, given the limited time of meetings. And the larger the group, the more centralisation of leadership becomes apparent (Goldstein, Heller & Sechrest, 1966). This also leaves less space for other group members to communicate. Another risk is that in larger teams, group members may unconsciously keep information to themselves because the value of that information is not known or seems to be hidden. This often leads to information asymmetry, especially when there is a lack of proactively getting and sharing information.

Hierarchical aspects in the group – related, for example, to boardroom experience or the cultural background of group members – may also play a role in people's willingness to share their own attitude, values, convictions and personal experiences.

We sometimes observe that newly appointed highly-experienced board members seem somewhat reluctant to take a stance that challenges the general opinion in the room. They seem to attach more value to respecting the board's current way of working than using their fresh perspective to propose a new outlook and enhance knowledge.

Even though courtesy is justifiable, board members were appointed for a reason and should be willing and able to fully participate and take the necessary action from the start.

The third element that impacts the communication climate is the disclosure of feelings. It is important that group members bring up what is personally important to them and that the group uses this information

in such a way that it facilitates meaningful communication and group development. Diversity plays a pivotal role here as it encourages groups to disclose different views and perceptions and to challenge and broaden existing or dominant perspectives and points of view. However, in order to strengthen the communication climate, a further exploration is needed of the group's diversity, as regards underlying values and convictions on an individual and group level. Addressing personal feelings means that what is felt and experienced in the room concerning certain topics is taken into account during discussions and decision-making. However, this is not yet common practice. Especially in case of incidents personal interests and reputational risks are clearly at stake and need to be addressed at the same time. On the other hand, inspections have also shown that in strong and mature teams group members are able to let go of the position they took prior to a meeting. This often leads to unexpected results, which could not possibly have been foreseen. These groups are able to conduct a constructive dialogue. As Bohm (1991) and his colleagues proposed participants are able to suspend their assumptions and group members view each other as colleagues or peers. In other words, group members appreciate that they are involved in a mutual quest for understanding and insight. And, last but not least, the chairman of the group often positions himself as a facilitator who 'holds the context of dialogue'. He simply points out issues that may be viewed as presenting sticking points for the group.

Communication Levels

Observations of board meetings sometimes reveal that group members can be so focused on their own agendas that they actually do not listen well or just hear part of a colleague's message, usually the part they expected to hear.

Generally, both listening and interpretive skills are not as strong as they should be in order to ensure a constructive dialogue. This can have negative consequences, such as group members blaming each other for a negative outcome, which creates a defensive atmosphere. Or members may use cautious wording because they feel misunderstood, personally attacked or ignored. Obviously, the preference is for an open climate where mistakes and misjudgements can be evaluated and discussed. Content and relationship aspects in communication are also regularly confused. For example, a question or remark relating to how things are being said is replied to with a solution for the subject matter actually discussed. Or matters that play a role on a relational level are handled through content.

Recently, the outcome of a board observation revealed that a group member asking a clarifying question in order to better understand the content of the meeting minutes was told by one of his colleagues that he "should read more carefully."

That colleague's answer was a personal response rather than a response to a semantic question. All the examples mentioned above lead to miscommunication among group members, which blocks an open and constructive communication climate and fuels defensiveness.

Communication patterns

As explained in the previous section, the easiest way to trace communication patterns is to keep track of the interaction frequencies between group members. These interaction frequencies provide information on the distribution of power, differences in status, coalitions and subgroups. During supervisory inspections, we noted that communication patterns may be influenced by the type and number of portfolios that group members hold. Especially when a member holds several portfolios simultaneously a lot of the interaction will obviously

be with that specific group member in charge. Inspections have shown differing levels of awareness of how these interaction frequencies may affect the functioning of the group. Sometimes the group does not proactively balance these interaction frequencies. If this is the case, group members do not sufficiently challenge the leader nor does the leader proactively seek the opinions of others. This may lead to a lack of supported and shared decision-making. In such cases, it is not uncommon to see active participation on one side of the table while the rest of the meeting remains passive or silent.

Another way of obtaining more information on communication patterns is to observe the roles that group members take during meetings. As touched on earlier, it is valuable to have group members who initiate and provide direction, members who support and provide completion, members who challenge and provide correction and, last but not least, group members who observe and provide perspective. Dysfunctional groups have often inadvertently silenced one or more of these members. In these instances, the group risks becoming biased in its decision-making. One example is courteous compliance, which suggests that there is agreement in the group when there may be none. Group members reflect only two action stances: some initiate and provide direction while others support and provide completion. This bias is particularly prevalent in teams that are just beginning to take shape. Group members act on autopilot, silencing their own abilities to challenge or observe and allowing a specific person in the group to be the sole initiator. This bias becomes particularly evident under time pressure. In such cases, it seems inappropriate or 'not done' to oppose or give a dissenting view – which of course requires time when taken seriously.

A variation on courteous compliance is covert opposition, which is another communication pattern observed by supervisory officers during inspections. Covert opposition is when someone makes a move and everyone else publicly agrees or reflects on the actions being proposed, without

acknowledging agreement or disagreement. Meanwhile, underneath these overt stances, group members harbour sceptical or oppositional thoughts. For example, when we conduct interviews with senior executives, some of them may express discontent about the direction one of the board members has taken. However, the next question is how they deal with this difference of opinion. DNB usually asks whether they have discussed their concerns with the respective board member. Sometimes supervisors get responses like “this environment does not allow us to challenge opinions” or “I could not possibly say this to the board member: he simply never listens”. And this is food for covert opposition. In such cases, the group members initiating action and those reflecting and suspending their opinions overtake the ability to discuss content freely and openly.

7.5 Risk mitigation – what do we expect?

This section focuses on the expectations financial institutions are required to meet concerning effective communication and which improvements or risk mitigation actions are required. The structure of this section follows the sequence of communication climate, communication levels and communication patterns.

Communication climate

As said, it is important for board members to communicate in such a way that they enhance supportive and prevent defensive climates (Gibb, 1961).

Table 7.2: Characteristics that enhance supportive or fuel defensive climates

Characteristics that enhance supportive climates:	Characteristics that fuel defensive climates:
<ul style="list-style-type: none"> ■ Description (focus on 'what and how') ■ Problem orientation (task focus, each member does her/his part) ■ Spontaneity (openness, self-disclosure) ■ Empathy (concern for others, taking perspective into account) ■ Equality (little status difference, use words like 'we', 'us', 'our') ■ Provisionalism (tentative/flexible: 'We could' ... 'One way we might do that is') 	<ul style="list-style-type: none"> ■ Evaluation (blaming, finding fault, 'why') ■ Control (manipulation of others to do my work) ■ Strategy (withholding information, cautious wording) ■ Neutrality (impersonal, 'whatever' attitude) ■ Superiority (us vs. them competition, cliques or coalitions) ■ Certainty (dogmatism, fixation on one way: 'My way or the highway')

The elements that foster a supportive climate (see Table 7.2) create a safe and open space in which individual board members are willing and able to pay attention and reflect on the three elements that we think are important building blocks for the communication climate. More specifically, a supportive climate helps board members to speak openly, to disclose personal information and to share perceptions and emotions. These conditions not only help board members to discuss the topics on the agenda, but also to take into account and articulate what is felt and experienced in the boardroom. It enables boards to connect what is 'on the table' and 'below the table'. In other words to connect the 'upper current' and 'undercurrent' (Bridges, 2005; Hoffman, 2012). Moreover, these conditions go a long way in diminishing relationship and process conflicts and facilitate constructive debate on task goals or outcomes. It is important to note that teams that have been working together in the same composition for a longer period of time find it more difficult to change. These teams need to make an extra effort to adjust long-standing embedded patterns in their communication.

In summary, we want financial institutions to invest in their communication climate. We found that group members who do so become more authentic and intrinsically motivated to explore new options and make choices that serve the greater good of the team and the company. And again, investing in expression of emotions has also been proven to be foundational to the pursuit of long-term virtuousness for individuals and teams. It enables them to quickly recover from difficulties, allowing them to adapt and grow (Stephens et al., 2013). Given the challenges facing the financial sector, this capacity seems necessary for survival.

Communication levels

As stated previously, the effectiveness of communication is also highly influenced by the use and interaction of communication levels. Although the focus is on the relationship level in the supervision of behaviour and culture, DNB is aware of how the content level is being used. Still, during these thematic inspections DNB does not evaluate substantive choices on a strategic or tactical level. What DNB expects group members to be aware of and to use as a guide for leading a constructive dialogue is the interplay of the content and relationship levels, and their impact on the quality of the conversation. We also expect the chair to keep communications balanced in terms of the different levels.

Moreover, DNB expects groups to use the relationship aspect to facilitate and empower valuable and substantive discussions. Skills that can be very useful to a chair include 'articulation': to succinctly describe what is going on, 'clarifying': listening, asking and reframing with the intention of simply testing different perspectives and 'making distinctions': in order to separate facts that have been tangled into – for example – one limiting, often disempowering, belief (Kimsey-House, Sandahl & Whitworth, 2011).

Communication patterns

Again, when observing communication patterns, DNB focuses on interaction frequencies and positions group members take in a conversation. DNB argues that a balance in positions taken also allows for a balance in interaction frequencies. Individuals with more balanced profiles – who are able to shift their action stances when they want to – are natural facilitators. Regarding the roles a chairman takes on during meetings, supervisory experience shows that a chairman who is able to support his team members in their communication and is able to express his reflections on the actions being taken in the team without acknowledging agreement or disagreement, enables the team to come to a close in discussions and to hold a broader perspective. These positions are especially important during difficult conversations. In order to prevent speakers from becoming stuck in one or more positions, and thus constricting the conversation space, teams need to address and value every participant's contribution to enhancing the quality of dialogue.

The different roles that group members take during meetings (for further details, see also section 7.3) may be strengthened and made more effective by consciously using the following skills: voicing, listening, respecting and suspending (Isaacs, 1999). For example, when initiating action or coming up with a proposal, learning to voice effectively may be an important skill. By giving up the need to dominate, initiators also enable other group members to be heard in the conversation, giving them an opportunity to react and respond to initiatives.

Another skill is listening. The better group members can listen, the more effective they will be in the role of supporting colleagues and helping to advance discussions. Respect for the other participants is crucial if group members are to oppose or to challenge viewpoints in a constructive way, keeping the conversational flow intact.

And finally, it is essential that those who reflect on the interaction without acknowledging agreement or disagreement are able to suspend their own ideas and opinions in such a way that all group members can examine the initiatives and proposals and see their strengths and weaknesses. Moreover, in line with the research of Argyris & Schön (1978), supervisory experience shows that a balance between inquiry and advocacy in conversations is important for effective communication. Inquiry requires reflection and support; advocacy requires a good balance between taking initiative and challenging. In other words, this is what the supervision of behaviour and culture asks group members to aim for in their communications.

Table 3: Supervisory expectations

Behaviour & culture focus in communication	Expectations
Communication Climate	<ul style="list-style-type: none"> ■ group members communicate in such a way that it enhances supportive and prevents defensive climates: they speak openly, bring up what is personally important to them and express their feelings ■ a climate indicating mutual trust ■ group members can connect what is 'on the table' with what is 'below the table' ■ financial institutions invest in the communication climate
Communication Level	<ul style="list-style-type: none"> ■ group members are aware of and able to observe communication on a content and relational level ■ the chairman keeps the communication on the right level and uses the relationship aspect to facilitate and to empower valuable and substantive discussions ■ the chairman uses skills like 'articulation', 'clarifying' and 'making distinctions'
Communication Patterns	<ul style="list-style-type: none"> ■ a balance in positions taken also allows for a balance in interaction frequencies <ul style="list-style-type: none"> - we want to see a balanced frequency of interaction - we want to see a balanced division of roles (initiating, supporting, challenging and observing) and all roles being present, the chairman focuses on supporting team members and expressing reflection without acknowledging agreement or disagreement ■ groups pay attention to how every participant contributes towards enhancing the quality of dialogue <ul style="list-style-type: none"> - using Isaacs' four practices: learning to voice, learning to listen, respect each other and suspend opinions in such a way that others can explore their strengths and weaknesses - balancing the positions people advocate and their willingness to examine their own views and those of others (advocacy and inquiry)

7.6 Conclusion

This chapter addressed why and how DNB takes communication into account while going through the supervision cycle of identification, assessment and mitigation when performing inspections. A better understanding and awareness of this topic largely prevents the development of longstanding ineffective communication. Healthy communication enables individuals and teams to recover quickly from difficulties, allowing them to adapt and grow and to become highly effective in impacting group and organisational performance in a positive way. As we mentioned, DNB's agenda for the coming years involves encouraging boards and management teams to recognise and acknowledge their own communication patterns as well as stimulating the willingness and capacity to make the necessary adjustments. This chapter therefore also provides information on how to provide for a healthy communication climate. At the same time, DNB is very much aware of the individual responsibility and self-efficacy that financial institutions need to build in the area of communication. After all, and despite the impact inspections on behaviour and culture can have, the results are just a snapshot in a much bigger timeframe. And it is probably not realistic to say that supervisors will hear and see everything that is needed or relevant. However, DNB wants to emphasise that it is more important for financial institutions to clarify the conscious choices top executives are making in creating conditions for a healthy communication climate. For example, how do boards align these conditions to the characteristics of their organisation and how do they tailor them to the context in which it operates? DNB wants to gain insight into the effect of the communication climate on boards and management teams over time. Questions to be expected include: "which developments can be seen and experienced in the communication climate, how do employees perceive this, or how does the financial institutions track them and how do teams cope with the challenges they are facing." The answers to these questions provide insight into group development and allow for measurable results over time. In this way, DNB strives for sustainable solutions without having to constantly monitor institutions or take over the reins.

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Group Dynamics

8.1 Introduction

The chairman of the Japanese parliamentary investigation committee that probed the Fukushima nuclear disaster¹ stated that the disaster was 'made in Japan'. Among a variety of causes that led to the disaster, his committee identified distinct behavioural patterns of the individuals and organisations involved. The dynamic between these individuals and organisations had a major influence on the behavioural patterns, which were embedded in Japanese cultural codes of conduct.

After the Tohoku earthquake and tsunami on 11 March 2011, flooding the reactors with seawater could have prevented the meltdown. Yet the decision to do so was delayed, partly because flooding would permanently ruin the costly reactors. Eventually the Japanese government ordered the flooding, but it was too late to prevent the meltdown. Evacuees of the surrounding area were sent to areas where radioactivity was even higher because Japanese government officials did not act on information provided by external agencies (Thirlwell & Blunden, 2012).

The Japanese parliament's Independent Investigation Committee identified the failures that led to the disaster (Investigation Committee report, 2012). These causes included poor communication and coordination between

¹ The Fukushima nuclear disaster is an illustrative example of group dynamics undermining organisational performance. Although it occurred outside of the financial context, we chose this example because of the major impact of the disaster and the parliamentary investigation committee's explicit acknowledgement of group dynamics as a cause of events.

officials and the government, meeting reports that were deleted, inadequate risk assessment and a lack of effective risk oversight. The following underlying dynamics and cultural elements were cited:

- A lack of trust between the major players:
the Prime Minister, TEPCO and plant managers;
- A reluctance to escalate bad news;
- Aspects embedded in national culture:
'our reflexive obedience, our reluctance to question authority;
our devotion to "sticking with the program", our group-ism;
and our insularity' (Investigation Committee report) along with a need
to save face.

This example illustrates the impact of group dynamic pitfalls within and between the groups involved in the disaster. It shows how cultural factors and social manners between key players (such as the lack of trust) influenced their actual behaviour, leading to this unfortunate end result. When people are at work, group dynamics are present and have an impact on behaviour and thereby on their performance.

DNB's supervision of behaviour and culture uses the iceberg model for its supervisory assessments. See Chapter 3 for an extensive explanation of this model and supporting theory. Key to the iceberg model is that there are drivers beneath the surface that drive and influence the exposed behaviour at the top. Group dynamics is one of these drivers. That is, the dynamics within a group drive behaviour regarding decision making, communication and leadership in that group. When, for instance, the dynamics in a group are tensed, this influences and drives the way the group members communicate with each other, the way they come to a decision, and the way the leader of that group behaves.

In order to mitigate behavioural risks, insight into and an understanding of underlying drivers and mechanisms is required. So, in order to mitigate risks that emanate from decision making, communication and leadership behaviour, it is essential to understand and assess group dynamics. It is therefore vital to understand the role and impact of group dynamics when assessing behaviour and culture. And, since group dynamics and the associated mechanisms as explained in this chapter impact behaviour and culture, they impact the stability and solvency of a financial institution.

Furthermore, dynamics are present within a group and between groups, driving the interaction between different divisions of business units, such as business and risk management. These mechanisms apply to the relationship and interaction between the financial institution and the supervisor as well. Analysing the dynamics within and the impact on the supervisory relationship with an institution, contributes to effective supervision.

Chapter Overview

This chapter starts with an exploration of relevant theories group dynamics (assumptions), followed by an explanation of how this theory translates to our focus in identifying group dynamics within financial organisations (risk identification). We elaborate on the risks these dynamics entail for the performance of a financial institution (risk assessment). Finally we describe our expectations of how financial institutions recognise and mitigate the pitfalls in their group dynamics (risk mitigation).

8.2 Assumptions

DNB's supervisory approach with respect to group dynamics is based on three different categories of assumptions that are derived from psychological research and theory.

- The first category of assumptions involves the relationship between group dynamics and group effectiveness, with a focus on four relevant aspects: performance of the group's members, its size, diversity and the group climate.
- The second category of assumptions relates to social processes in groups that underlie group dynamics: social identification and social categorisation.
- Finally, we assess group dynamics at a certain moment in time and in a specific context. Team development is relevant for interpreting our findings. Therefore the third category of assumptions concerns team development.

All these assumptions have implications for the scope and depth of our supervisory inspections. Before going into these three categories of assumptions, we will start by defining group and group dynamics.

A definition of group and group dynamics

From a psychological perspective, a group is 'one that is psychologically significant for the members, to which they relate themselves subjectively for social comparison and the acquisition of norms and values, that they privately accept membership in, and which influences their attitudes and behaviour' (Turner, 1985; Forsyth, 1999). This implies that the behaviour of groups is not only impacted by individual elements, such as personality or attitude, but that the existence of the group also influences the attitudes and behaviour of its individual members (Lewin, 1947). In our assessments, we define group dynamics as the interaction between different positions and patterns within a group or between group, which affect the overall group effectiveness.

Group effectiveness

Group effectiveness, or the performance of the group, is influenced by at least four aspects. Firstly, effectiveness of the group is influenced by the

performance of its members. Steiner's social combination theory (1972, 1976) argues that group effectiveness depend in large part on the resources that the group members contribute and whether those resources are effectively combined. These resources include members' knowledge, skills, abilities and characteristics.

The second aspect influencing group effectiveness is the **size** of the group. Groups usually become less productive as they increase in size, the so-called 'Ringelmann effect' or 'social loafing' (Karau, Steven, Williams & Kipling, 1993). This is not only caused by coordination losses, but also by the fact that individuals reduce their effort when working in a group. This reduction is caused by dissociation from individual achievement and the decrease of personal accountability. It is a rather sticky issue that is hard to correct. Enlarging the group can have a detrimental side-effect on group performance. Performance improvement can be attained by the compensation effect: when people are personally interested in the group's task, they can compensate for other group members. People also exert more effort when they feel that their contributions to the group are indispensable and that others will not free ride. Additional important factors are clear and challenging group goals and confidence in the group's ability to reach its goals (collective efficacy) (Forsyth, 1999).

Thirdly, the **diversity** within a group influences its performance. Research into the effects of diversity in organisations reveals varying results and shows that diversity is associated with positive and negative effects (Williams & O'Reilly, 1998; De Haan & Vlahu, 2013). The positive effects of diversity are the increased quality of group performance, creative thinking and decision-making (Milliken & Martins, 1996). Other studies (see Milliken & Martins, 1996 for an overview) indicate negative effects such as decreased group cohesion (O'Reilly, Caldwell & Barnett, 1989) and an increase in conflict (Jehn et al, 1999; Pelled, Eisenhardt & Xin, 1999).

Finally, **group climate** is the fourth aspect that influences group effectiveness. We define group climate as the degree of positivity and connectivity in a group. Research shows that a supportive group climate generates positivity or positive emotions. These positive emotions create emotional spaces, unfolding possibilities for action and broadening action repertoires. Positive emotions also strengthen connectivity in the group and build durable, physical, intellectual, and social resources (Frederickson, 1986). Moreover, there is a positive correlation between the role of positivity and connectivity in the performance of business teams, and the team capacity to deal with increasingly complex environments such as the financial sector is currently facing (Stacey, 1996).

In Chapter 7 we stated that the communication climate is an indicator that tells us something about the degree of openness and closeness in communication. The nature of interpersonal relationships, disclosure of personal information and disclosure of feelings are important elements that determine the communication climate. In our view, the communication climate and group climate resemble each other and are closely linked. Since communication is an expression of underlying group dynamics, we consider it as a strong indicator of the group climate.

We assess the group climate – i.e. get a sense of the degree of positivity and connectivity within a group – by exploring the following four sub-factors:

- (i) the nature of interpersonal relationships,
- (ii) the degree of cohesiveness in a group,
- (iii) the way the group deals with conflict and
- (iiii) the balance between task and relationship orientation within a group. We will discuss these indicators in detail in the section on risk identification (8.3).

Social identification and categorisation

Two basic social mechanisms, which manifest in any group, underlie the

impact of the previously mentioned four relevant aspects (performance of group members, size, diversity and group climate) on group effectiveness: social identification and social categorisation.

Identification is a psychological process that refers to attaching and committing oneself to something or someone else, for example colleagues, a work team or the employer. Identification is a relevant psychological process on the work floor, because effective teamwork demands that team members recognise the team as a unit with common goals, standards and values (Lembke & Wilson, 1998). The more team members identify with each other, the more likely they are to assume they have the same goals and values, and the greater their willingness to cooperate (Haslam, 2001).

An important theoretical perspective that forms the basis of much experimental and applied research on identification in the work context is the Social Identity Theory (Tajfel, 1978; Tajfel & Turner, 1979). According to this theory, individuals adopt part of their identity and self-perception from the groups to which they belong. They begin to conform to the norms of the group because identifying with a group is emotionally significant. For example, a group norm of competitiveness usually leads to colleagues who compare themselves to their co-workers and strive to be the best. The risk here is that this aim goes at the expense of the group members' mutual understanding and good relationship. People's self-esteem will become bound up with group membership and they will feel more confident and proud because they are part of the team. In short, identification influences individual and group behaviour (Hogg & Terry, 2001).

Furthermore, social research shows that people tend to value their own group more positively than other relevant groups (see also Zick, Wagner, Van Dick & Petzel, 2001). The Social Categorisation Theory explores this mechanism further (Hogg & Terry, 2001; Turner, 1985; Turner, Hogg, Oakes, Reicher & Wetherell, 1987). People categorise themselves and others based on differences and similarities. This is done for a variety of reasons: to evaluate their own qualities, to set personal goals, to help other people,

or – so they hope – to discover that they are superior to the people around them (Helgeson & Mickelson, 1995; Wood, 1996). The effect of this categorisation process is that in-groups (us) and out-groups (them) are defined. Defining the world in terms of 'us' and 'them' makes things clearer.

Research has shown that any difference between group members (especially visible demographic differences) can threaten the unity of a group and will very likely have a negative effect on the interactions in a group (see Gruenfeld, Mannix, Williams & Neale, 1996; Jehn, Northcraft & Neale, 1999; Van Knippenberg & Haslam, 2003; Veltrop, Hermes, Postma & De Haan (2015). The risk of such 'us-them' group dynamics is a lack of trust and psychological safety, which reinforces negative organisational outcomes such as conflict, discrimination, non-attendance and outflow.

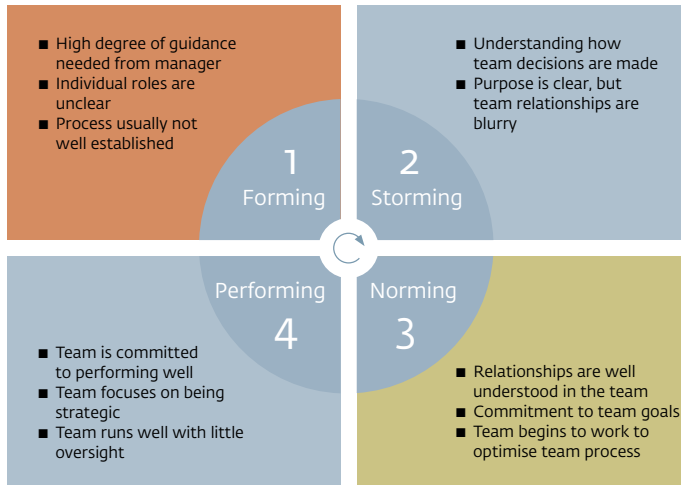
In summary, social identification and categorisation influence the dynamics and climate of a group and hence group effectiveness. In our supervision we take these processes into account when we assess group dynamics and its effect on group behaviour.

Team development

In our supervision we assess the dynamics within a group at a certain moment in time and in a specific context. To interpret observed dynamics, we consider how long the group has been together as well as what tasks and collective experiences it has. The way the group has developed is an important context factor. Tuckman² (1965) defines five phases in team development.

² Tuckman's model has practical advantages for supervising group dynamics. See Wheelan (2009) for more recent work on group development.

Figure 8.1. Tuckman's model for Team Development



The different phases in this model are associated with specific characteristics and behaviours. In Tuckman's model, each phase can be defined in terms of two aspects: interpersonal relationships and task behaviours. The model explains that as the team becomes more mature and competent, relationships become more established. In the first phase of the model, the forming of the team takes place. Team members are driven by a desire to be accepted by the others, and avoid controversy or conflicts. In the storming phase, enough initial trust has been developed between team members so they start to feel comfortable expressing discontent and challenging others' opinions. This phase is necessary to grow as a team because task-related disagreements within the team can make members stronger, more versatile, and able to work more effectively. In the third norming stage, the team manages to have a shared goal to reach a mutual plan and a shared norm in terms of appropriate behaviour and group dynamics for the team. Some team members may have to give up their own ideas and agree with others to make the team

function. The risk here is that members may be too focused on a shared goal and that they are reluctant to share dissenting views and ideas and avoid constructive debate and conflict. Some teams are able to reach the performing stage. These high-performing teams can function as a unit as they find ways to get the job done smoothly and effectively without disruptive conflict. The last stage, adjourning, involves completing the task and breaking up the team. Many long-standing teams go through these cycles many times as they respond to changing circumstances.

The model explains that the developmental phase of a team influences the dynamic and climate of a group and therefore impacts its effectiveness. In our supervision we take the developmental phase of a group into account when we assess group dynamics and its effect on group behaviour.

After having explored the relevant theory on group dynamics, its relation to group effectiveness and underlying social mechanisms, the next section explains how this theory is translated to the way we identify group dynamics and the attendant risk for group effectiveness.

8.3 Risk identification

– what are our points of interest?

DNB's supervisory approach to assessing group dynamics focuses on the following aspects of a group and its dynamics.

1 Group composition

- a. diversity and performance of group members
- b. size

2 Group climate

We assess group climate – the degree of positivity and connectivity – by focusing on four aspects:

- a. the nature of interpersonal relationships,
- b. the degree of cohesiveness,
- c. the way the group deals with conflict and
- d. the balance between task and relationship orientation.

Looking at these indicators, we identify aspects that enhance or impede a supportive group climate, such as a climate of positivity and connectivity.

1 Group composition

a. Diversity

The first is the composition of the group, where we focus on diversity and the performance of its members as well as group size.

When looking at diversity and the performance of the members of a group (1a), we observe whether a group contains an appropriate mix of specialised expertise and whether diverse perspectives and opinions are present and used (Lorsch, 2012). Indicators we use in our desk research to evaluate these aspects are the personal differences in the group such as age, education, competences and skills, experience and background.

As the context of financial institutions differs, the optimal mix of 'resources'

needed differs. In our board observations and interviews we explore whether the institution is able to gain from the positive sides of diversity, such as increased quality of group performance, creative thinking and better decision-making.

b. Size

However there are additional factors that determine whether diversity is effective, such as the size of the group (1b). When the group is too small, it is difficult to achieve sufficient diversity, and when the group is too large, it is difficult to become actively involved in discussions, and the risk of social loafing rises. It is unclear what the optimal group size is. We believe it depends on the context and applicable legislation.

For example, in the case of a pension fund, legislation prescribes that different stakeholders must be represented on the board. In general, our view is that the optimal size for an effective group is as large as needed and as small as possible. In our observations and interviews we also examine whether all group members contribute to the quality of the decisions made. Ensuring availability of diverse knowledge and competences within a group is not sufficient; it is important that diversity is well used.

2 Group climate

a. The nature of interpersonal relationships

Here, we observe whether relationships between group members are constructive or defensive. If the nature of interpersonal relationships is constructive, it supports an effective group climate (Frederickson, 1986) and is often characterised by teamwork, a give and take between group members and formulation of open and neutral questions. If the nature of interpersonal relationships is defensive, it inhibits an effective group climate and is often identified by a degree of blaming among group members and the formulation of 'why' questions. As stated before, communication between group members is an indicator of group climate. To observe the nature of interpersonal relationships, we focus on communication between group members, see also Chapter 7.

b. Cohesion

Cohesion refers to the tendency for a group to be in unity while working towards a goal or to satisfy the emotional needs of its members (Carron & Brawley, 2000). Cohesiveness helps the group to function smoothly and contributes to positivity and connectivity. However, too much social cohesion has downsides. It can result in biases, such as the in- and out group bias, in group conformity as well as groupthink: an excessive form of concurrence-seeking among members of a high prestige, tightly knit policy-making group (Janis, 1972). A cognitive bias is a pattern of deviation in judgment, whereby inferences about other people and situations may be drawn in an illogical fashion (Haselton, Nettle & Andrews, 2005). This definition shows the possible detrimental impact of biases on the quality of decision-making, leadership and communication, hence on group performance. Because of this, we also look for the presence of biases in our assessments. Common biases (not limitative) that are prevalent in groups are summed up in Table 8.1.

Table 8.1 Overview of five relevant biases in assessing group dynamics

1 Confirmation bias	tendency to search for, interpret, focus on and remember information in a way that confirms one's preconceptions
2 Recency bias	tendency to extrapolate recent events to the future
3 Attribution bias	tendency to attribute successes to oneself and failures to external factors
4 Black swans	tendency to underestimate risks
5 Planning fallacy	tendency to overestimate the proceeds and underestimate the costs

In identifying cohesiveness of a group, we focus on how the group deals with dissenting opinions, from other group members as well as from other groups. We see to what extent disconfirming information is discussed. We assess how the cohesiveness of the group influences its decision-making process. A group that has strong cohesiveness can be tempted to avoid discussing disadvantages or inviting specialists to provide information or challenge the group's decisions on important topics.

c. Dealing with conflict

Research shows that the way group members deal with conflict directly impacts group performance (Jehn & Mannix, 2001). Assuming that there is always some sort of conflict in teams, it becomes relevant to consider how much and when, rather than if, conflict occurs. And then to determine how to deal with conflict using communication as a way to steer the group in a desired direction. High-performing groups handle conflicts in an open and active manner, characterised by open discussion norms and high levels of respect among team members.

d. Task or relationship orientation

When assessing group climate, we identify the balance between relationship and task orientation within a group. Research shows (Jehn, Greer, Levine & Szulanski, 2008; De Dreu & Vianen, 2001) that a weighted balance between task and relationship orientation – or the degree to which group members are focused on their task or focused on the person with whom they are doing it – contributes to the effectiveness of a group. When a group is strongly oriented towards its task, it may pay insufficient attention to the members' interpersonal relationships, risking inhibited performance. On the other hand, a strong relationship orientation might lead to insufficient attention to the task at hand. Furthermore, Jehn distinguishes between task and relationship (Jehn et al., 2008). Task conflict includes disagreement about the 'distribution of resources, procedures and policies, and judgments and interpretations of facts'. Relationship conflict refers to conflicts based on people's interpersonal

style or values. It is generally acknowledged that relationship conflict is universally bad for group performance (De Dreu & Vianen, 2001).

Status differences

In our assessments we focus on the dynamics within a group ('intragroup dynamics'). Nevertheless, we encounter relevant dynamics between different groups, such as the dynamics between a management (or executive) board and supervisory (or non-executive) board, or between a business unit and risk management. When looking at the dynamic between groups (besides the aspects mentioned earlier in this chapter) the presence of status differences, is specifically relevant in our supervision.

In building a robust organisational framework that signals, manages or prevents problems, most financial institutions use the 'Lines of Defence (LoD) model'. In this model the first line identifies and manages risks directly. The second line monitors the design and operation of controls in the first line, provides advice and facilitates risk management activities. The third line is responsible for independent assurance to the management of risks. In this model it is vital that the second and third line own and exercise enough countervailing power to challenge and control the first line. As people from the different lines work in separate departments or functions, all kinds of social identification and categorisation pitfalls can arise which can have a detrimental effect on the robustness of the financial institution. In all the instruments we use, this is an important topic we explore: Is there a healthy dialogue between the different groups and are they able to really listen to each other? How are perspectives from different groups incorporated into the decision-making process? How critical is the supervisory board towards the management board?

Table 8.2 provides an overview of the different touchstones and indicators we use when observing group dynamics. We identify group dynamic risks by using a variety of assessment tools: desk research, self-assessments, interviews and observations. In Chapter 4, our methodology and the

use of these tools are explained in detail. Observing group dynamics and identifying risks is not an algorithm, as the relevant social mechanisms are interrelated. Therefore, expertise is required in assessing group behaviour to identify and interpret dynamics in a professional way.

Table 8.2 Indicators for assessing group dynamics

Behaviour & culture focus in group dynamics		Indicators
Group composition	a. Diversity and performance of members	<ul style="list-style-type: none"> ■ level of diversity such as education, gender, competences/skills, experience (e.g. work field), background ■ equivalency in contribution
	b. Size	<ul style="list-style-type: none"> ■ adequate group size ■ equivalency in contribution
Group climate	a. Nature of interpersonal relationships	<ul style="list-style-type: none"> ■ constructive or defensive nature ■ communication between group members: open/neutral questions or 'why' questions
	b. Cohesion	<ul style="list-style-type: none"> ■ balanced weighting of disadvantages, discussing disconfirming information ■ biases
	c. Dealing with conflict	<ul style="list-style-type: none"> ■ the way conflicts are dealt with ■ level of respect between group members open communication
	d. Balance task/relationship orientation	<ul style="list-style-type: none"> ■ task vs. relationship-oriented communication between group members task or relationship conflicts
Status differences	Assessed when looking at dynamics between different groups.	<ul style="list-style-type: none"> ■ quality of dialogue between different groups ■ openness to diviant views/ opinions ■ level of countervailing power from second/third line or supervisory/non-executive board

8.4 Risk assessment – what do we see?

After having described the identification of risks related to group dynamics, in this section we illustrate our assessment of these risks using two examples we derived from our supervisory practice.

During an inspection we focused on the relationship between the working floor of a business division and compliance within a bank. Within this bank, compliance and the business floor were located in different parts of the building. Communication and a constructive working relationship between the business and compliance was under pressure. The psychological distance between these functions contributed to this. The unhealthy tension between business and compliance, in contrast to the healthy tension that is inherent to a business – control relationship, manifested itself in the frustration compliance staff had about the fact that they were always the ones that reached out to business. Business rarely reached out to them for consultation. Compliance felt the business was not taking the role of compliance seriously, and that business staff did not take its responsibility in managing its own compliance risks. Conversely, business staff felt it was only logical for them to remain at their desks. After all, they were the ones making money for the bank, and compliance was blowing things out of proportion. As a result, their constructive working relationship was tensed and they avoided communication.

Our first example involves the dynamics between business and control functions and illustrates the impact of these dynamics on communication. The business function and the compliance function have different roles and responsibilities. This strengthens certain negative group dynamics, such as in- and out group bias (Tajfel, 1978; Tajfel & Turner, 1979; Turner, 1985;

Turner et al., 1987). Ingroup refers to the group you belong to, the outgroup means the 'other group'. In- and outgroup bias means that people are less positive about the people that are not part of their group, leading to inadequate communication. An important risk regarding communication arises when these biases are not well-managed. When people feel that they are inaccurately judged, this inhibits a substantial dialogue and results in a lack of understanding for the various views. It hinders acceptance of the opinions of the outgroup. This can delay decision making. Delaying decisions, especially compliance interventions are considered a huge risk.

In the financial context, what we have observed is that where biased views between groups are not well-managed, people shift in their role and task perception in order to solve or deal with tensed working relationships. The development of the compliance function is a good example. This role has developed rapidly in recent years from rule-based to risk-based, from incident-driven to pro-active and from enforcement to influencing behaviour. These developments enhance the effectiveness of the compliance function, and they also address the tension between business and compliance functions.

A second example involves the dynamics within a supervisory board (SB) affecting balanced decision making. This SB was quite diverse in terms of the nationalities of its members, which led to subgroups within this SB. As a result, the communication between SB members decreased and the collectiveness of the SB as a whole was impaired. Another effect was that a small group within the SB was formed being pre-informed about matters and having a disproportionate influence on the outcome in decision making processes in relation to the other SB members. The chairman of the board, who was part of the small group that had disproportionate influence, admitted that he found it hard to manage the dynamics in this multinational and large SB. He was aware of potential beneficial effects of diverse opinions and (national) backgrounds on the quality of the SB work. Using this diversity for the better was harder than he realised. When for instance talking about the integration of new SB members he said: 'I had not realised that it would be so difficult for me to really listen to alternative views rather than explaining to new members our way of doing things.'

Our second example illustrates how group dynamics impact decision making: a subgroup had disproportionate influence on the outcome, and diversity in opinions due to diverse nationalities and the arrival of new SB members was left untouched. In our supervisory practice we see that a great deal of attention is devoted to diversity and that boards intend to compose diverse teams. However, especially in boards, it remains challenging to create teams with board members that differ in terms of, for instance, professional backgrounds, gender and age. When institutions succeed in composing a diverse team, they immediately face the next challenge: making diversity work. We see that the presence of people with

different backgrounds often results in the creation of subgroups or majority and minority groups. This often leads to information asymmetry, leading to disproportionate weighing of opinions or board members insufficiently contributing to discussions. Preventing information asymmetry and creating room for aberrant opinions and approaches is essential in using diversity of a board to enhance the quality of the SB's decisions and views. To counter group pressure and conformity biases, the chair of the SB and the SB as a whole are responsible for organising a dialogue in which there is room for expressing new ideas and minority views, and in which such ideas and views are responded to seriously and with curiosity.

8.5 Risk mitigation – what do we expect?

We expect financial institutions to mitigate behavioural risks by improving their group dynamics, among other things. To improve the dynamics within and between the groups in their organisations, there should be sufficient awareness of the nature of these dynamics and the impact they have on decision-making, leadership and communication. Our supervisory assessments aim to raise that awareness and urge improvement of ineffective group dynamics. In this section, we clarify our expectations.

Group composition

It is important to consider group composition, size, diversity and performance of group members. A direct instrument used by DNB to influence group composition is the new policy on suitability screening, which aims to safeguard healthy group dynamics in boards.

Not surprisingly, the composition and quality of the other board members is taken into consideration in this screening process. Suitable candidates have appropriate and complementary knowledge, skills and behaviour.

Which competences are relevant, depends on the position the candidate is applying for and the type, size complexity and risk profile of the organisation. Responsibility, judgment and independence are important

competences for all board members. From this perspective, succession planning is important. We expect timely attention for recruiting and developing talent, taking account of diversity. In our supervision, succession planning can be a theme when we see or foresee problems regarding a lack of diversity or pitfalls related to group dynamics.

Group climate

Regarding group climate, it is essential for group effectiveness to stimulate a healthy degree of positivity and connectivity within the group. To achieve this, sufficient attention must be paid to the four aspects discussed in this chapter: the nature of interpersonal relationships, the degree of cohesiveness, the way conflicts are dealt with and the balance between task and relationship orientation. It is important that there is an appropriate level of cohesion in the board: not too little or too much because both sides of this spectrum have negative consequences for group dynamics. We think organising the appropriate level of cohesiveness is one of the chairman's most important tasks. We also expect that in the group, attention is paid to cohesiveness and other group dynamic processes with a view to mitigating the accompanying pitfalls. This requires adequate leadership, a well-organised decision-making process and effective communication. If the group lacks adequate knowledge of social processes, external advisors can play a role in discussing the group dynamics, reflecting on the positive and negative consequences and helping the group to improve effectiveness. In these reflection sessions, we think it is important to consider incidents or problems, to analyse the root cause and to integrate double-loop learning. It is not just content but also process and collaboration in and between groups that could contain relevant root causes for preventing or solving (repetitive) problems. Sometimes just explaining the existence and the impact of such aspects as the in- and outgroup bias can clarify a lot and contribute to improving collaboration. In our inspections we ask, for example, how many times a year the group organises this type of meeting and what agreements were made during the last one.

Table 8.3 Supervisory of expectations

Behaviour & culture focus in group dynamics		Expectations
Group composition	a. diversity and performance of members	<ul style="list-style-type: none"> ■ appropriate and complementary composition ■ attention to talent development and succession planning ■ all group members have competences such as responsibility, judgment and independence
	b. size	<ul style="list-style-type: none"> ■ the size of the group is adequate, ensuring effective use of available skills and diverse competences
Group climate	a. interpersonal relationships	<ul style="list-style-type: none"> ■ chairman organises an adequate level of cohesion
	b. cohesiveness/ conflict	<ul style="list-style-type: none"> ■ attention is paid to the pitfalls of group dynamic processes
	c. task/relationship orientation	<ul style="list-style-type: none"> ■ the root cause of repetitive problems is examined
Status differences	Assessed when looking at dynamics between different groups.	<ul style="list-style-type: none"> ■ adequate amount of countervailing power must be safeguarded and rebalanced when necessary

Status differences

Social identification and categorisation can have detrimental effects on the collaboration between groups. We have explained how this can influence the robustness of the organisation and how we examine this. We have also described the influence this can have on the Lines of Defence Model and that it can negatively influence the robustness of the organisation. In light of this, we think a crucial role of the board's chairman and the supervisory board is to recognise whether the organisational model, for example the LoD model, functions adequately. An important condition here is that roles and responsibilities are clear for different functions or departments. In addition, the (supervisory) board must ensure that the different roles and departments take the necessary action to ensure there is enough countervailing power. This can be determined by asking about it, but also deduced from indicators such as how much advice from the second line is adopted and implemented or whether the first line accepts and acts on findings from the third line. If these aspects are not functioning adequately, the board and especially the chairman of the board can rebalance the situation by supporting the function or department that needs extra help to make the organisation model work effectively.

On a final note, we would like to emphasise the importance of groups' learning capacity. Experts argue that double-loop learning is critical to the success of an organisation, especially during times of rapid change (Argyris & Schön, 1974). First-loop learning refers to group members establishing rigid strategies, policies and procedures and then spending their time detecting and correcting deviations from the 'rules'. Double-loop learning is about group members' ability to reflect on whether the 'rules' themselves should be changed, not only on whether deviations have occurred and how to correct them. Important conditions for double-loop learning are the ability to evaluate and reflect. We therefore expect financial institutions to examine the root causes of (repetitive) problems and organise structured evaluation and reflection sessions.

8.6 Conclusion

Group dynamics drive groups' behavioural patterns in a professional context. They impact patterns in decision-making, leadership and communication, and therefore impact the effectiveness of a group. Effective supervision of behaviour and culture assesses group dynamics and the way they drive behaviour. Group composition, group climate and status differences are important touchstones in assessing group dynamics. In this chapter, we have elaborated on how risks related to group dynamics can be identified, assessed and mitigated. We expect financial institutions to pay attention to their group dynamics through evaluation and reflection. Furthermore, we expect group dynamics to be improved when they impair behavioural patterns and group effectiveness.

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Capacity for Change¹

'It is not the strongest of the species that survives, nor the most intelligent, but rather the one most responsive to change.'

9.1 Introduction

This well-known saying that paraphrases Charles Darwin (see Megginson, 1963, p.4) also applies to organisations. The financial sector is clearly facing major changes. These changes are necessary to bring about a stable and financially sound sector that exercises due care when providing financial services to customers. Also, they are necessary in order to regain public trust in the financial sector.

In 2012, De Nederlandsche Bank (DNB) and the Netherlands Authority for the Financial Markets (AFM) decided to perform a joint study of the sector's capacity to implement major changes. In line with the increasingly forward-looking role played by supervision, DNB and AFM have decided to study this matter with the aim of gaining an understanding of the existing capacity for change within the financial sector and improving this capacity for change.

In this chapter we describe how DNB and AFM have assessed this 'capacity for change'. We also discuss the success factors and impediments as well as the role played by supervision.

¹ This article is based on another article by the author Jildau Piena and C.A. (Céline) Christensen, AFM's Treating Customers Fairly domain manager, 'Mag ik van u twee frappuccino's en één integrale cultuurverandering', which appeared in the Compliance Yearbook 2015.

We start by explaining the assumptions underlying our supervision of culture change (9.2). Section 9.3 explains our supervision model on Capacity for change and how we applied this model in our study of capacity for change in the financial sector (9.4). We describe our points of interest in the section on risk identification (9.5) and we elaborate on risk assessment in section 9.6. We conclude this chapter by stating our expectations of financial institutions in the final section about risk mitigation (9.7).

9.2 Assumptions

The change task for the financial sector is profound

The financial sector has introduced measures in many areas in recent years, and change has been seen in the form of adjustments to strategy and core values, as well as in specific matters such as mortgage interest policy and improved information on products. These are far-reaching measures that can be of great benefit to consumers, but at present they are primarily instrumental adjustments to systems, processes and procedures.

The question is whether these measures intervene deeply enough to change the financial sector in a fundamental and sustainable way. Namely, changes leading to a sound, robust and ethical financial sector that focuses on the interests of customers, demands that further changes be made to the business model, that perverse incentives be removed, that the entire organisation be motivated to change, and that behaviour and culture actually change. That is quite a challenge that demands a different approach, as asserted by many in the top echelons of the financial sector.

At the same time, this ambitious agenda for change needs to be carried out by a sector that continues to struggle with its reputation. Public trust in financial institutions has been seriously dented by the crisis (Jansen, Mosch & Van der Crujssen, 2013). Restoring public trust has been hampered by problems within the financial sector, such as the debate about bonuses, shady unit-linked policies and the slow settlement of

claims, the nationalisation of financial institutions and the LIBOR scandal. Consequently, the public, politicians and supervisory authorities are continuing to demand fundamental change.

Knowing that the financial sector has major changes to realise, what is the role played by the supervisory authorities in assessing capacity for change? The next section will explain which assumptions underpin the supervision on organisational change.

Supervision and assessment of organisational change

As supervisory authorities for financial institutions we have traditionally focused on the principal risks. Given the major challenge outlined above, in addition to our existing supervision efforts we also need to be able to form an opinion on whether financial institutions create the right conditions to change and if they are able to realise them. If the changes that are being implemented are not sustainable and successful, this could eventually pose a significant risk to the sector and society. The same could happen if the financial sector fails to respond quickly enough to external developments. Consequently, supervisory focus is also directed on organisational change. But how do organisations ensure that they actually realise sustainable changes? And how do they make adjustments if their approach does not seem to be working or the situation changes drastically?

As supervisors, we intend to anticipate on the risks of failure to change, since the literature frequently mentions a failure rate of 70% of planned changes (Kotter, 1996; Keller & Aiken, 2008; Blanchard, 2010). Although this figure is somewhat open to question, it is a fact that many planned changes are not successful. As stated earlier in Chapter 2, we believe that supervisors have an obligation and a legal mandate to identify risks concerning behaviour and culture, and we expect financial institutions to mitigate these risks. More specifically, supervisors should set the agenda in terms of a greater focus on risks related to organisational change and encourage the financial sector to identify and mitigate those risks.

At the same time, primary responsibility for intervention and mitigation of behaviour and culture risks lies with the financial institution. In our supervision we tap into the autonomous motivation of financial institutions and their boards, in order to induce them to manage organisational culture and intervene in behaviour and culture risks.

DNB addresses strategic change as a process that impacts the organisation as a whole, including behaviour and culture (see our basic supervisory assumptions on an integral and contextual perspective in Chapter 3). Our supervisory approach to change is based on this notion of an integral and contextual perspective. Yet, the results of our thematic review on capacity for change (discussed in this Chapter) show that behaviour and culture are hardly awarded the same status and priority as structure (new roles, functions and responsibilities) or strategy (new business model or mergers) during strategic change processes in the financial sector.

Cultural changes are even more problematic (Ten Have et al., 2009). Cultural changes are difficult to achieve and seem to fail regularly because culture change not only implies new learning but also involves unlearning, which is intrinsically difficult and usually painful (Schein, 2006). And as biology dictates, humans tend to avoid pain – they either fight, flee or freeze. As a result, action is often not taken at the right level, i.e. at the root of behavioural problems. In general, interventions do not seem to be far-reaching enough.

Culture change is a specific kind of organisational change, requiring specific competences and focus from the management board that may differ from those required for organisational change in general. Several institutions in the financial sector have launched specific programmes or initiatives that intervene in their existing organisational culture. We have developed a specific supervisory model and methodology for these strategic culture changes. This model is explained in Chapter 10.

In sum, DNB's supervision is also directed at change processes in financial institutions. This Chapter explains the assumptions, supervisory model and approach for all types of organisational change. Chapter 10 deals specifically with at supervision of culture change in financial institutions. Both chapters are situated in the same context and are rooted in the assumptions and supervisory approach to supervision on behaviour and culture as explained in Chapters 3 and 4.

9.3 Supervision model on capacity for change

Definition: What is capacity for change?

In order for a supervisory authority to form a clear picture of the capacity for change in the financial sector, it is important to first think about what capacity for change actually means. We consider an organisation's capacity for change to be the degree to which groups of people within that organisation are willing and able to effectively implement the desired change and make it work. Are plans actually put into practice? This also involves the ability to make adjustments if the approach does not seem to be working or if circumstances change drastically. In other words, capacity for change also includes the ability to apply reflective learning skills.

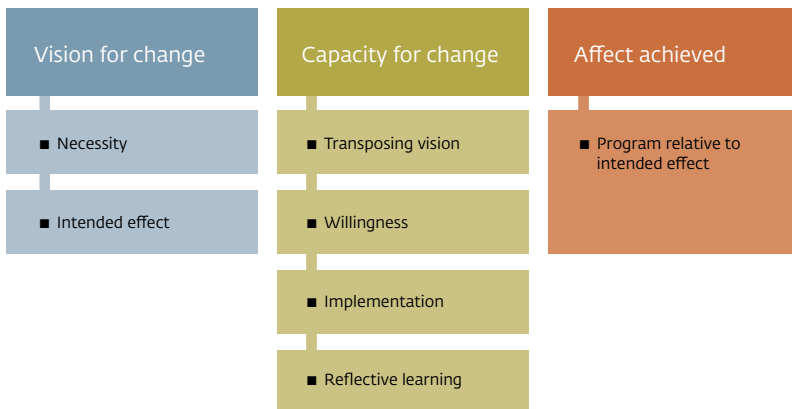
An organisation's structure and effectiveness depend on the situation in which it finds itself (e.g. environment, technology, size).² An organisation's capacity for change is linked to a specific change process. Successes an organisation achieves in one specific area at one particular moment in time cannot simply be copied to the rest of the organisation. The difficulties facing a corporate banking department, for example, are different from those encountered by a compliance department.

² This is based on the Contingency Theory, which gained traction in the 1970s and is still valid (Scott, 1981).

AFM and DNB have developed a research model for assessing the degree to which the Dutch financial sector is capable of change in practice. This is in line with the common thinking in scientific literature on organisational change where change-processes usually consist of different sequential steps (Kotter, 1996) or building blocks that are strongly linked (Lewin, 1952; Tushman & O'Reilly, 2002; Cummings & Worley, 2004; Ten Have et al., 2013).

We looked for a model that is useful for supervisors with different backgrounds and then we trained them to use this model. Most of the models in change literature contain the same elements as those used in our methodology. To ensure that knowledge about change remains up to date, we discuss recent developments in the area of change management with change experts on a regular basis. With this in mind, knowledge is also shared with researchers, change experts at financial institutions and people working for leading consulting firms operating in the financial sector.

Figure 9.1 Capacity for change model



In our study, the capacity for change was documented on the basis of four aspects, which are specified in the above figure. The model assumes that a change will be successful if attention is paid to these four aspects

or buildings blocks. These aspects are derived from the building blocks referred to in the change literature (Lewin, 1952; Kotter, 1996; Tushman & O'Reilly, 2002; Cummings & Worley, 2004; Ten Have et al., 2013).

In its vision for change, the organisation describes where it wants to go. This vision may take very different forms, ranging from a rough sketch to a detailed document. The 'achieved effect' describes the ultimate outcome of the ambitions.

In the study we took the organisation's 'vision for change' and the 'achieved effect' to be given facts. Obviously, aside from this study, AFM and DNB exercise supervision in this area in a number of ways. In this study, we focused on the central column, i.e. how to move from vision to effect.

9.4 Practical application: two years of research into capacity for change

The model described above was used in the first large-scale study of capacity for change in the financial sector. An impression of the capacity for change at the organisations that took part in the study was gained by testing the aforementioned elements.

Design of the study

Capacity for change was studied at seven large financial institutions. Working in close consultation with the organisations, we selected various change processes at each organisation as the subject of our study. The subjects of our study varied in terms of their scale and level in the organisation to which the change related. These included aspects of a cultural change programme or the introduction of practical new procedures in a specific department.

Many of the subjects of our study were a mix of more and less successful change processes and projects that had already been completed or were still underway. At each organisation we looked for the success factors that enabled the studied changes to get off the ground and the factors that prevented this. As the supervisory authority, our aim was not so much to study specific incidents as to identify patterns.

9.5 Risk identification - what are our points of interest?

Transposition of vision

The first element we looked at in our study was the way in which the organisation transposed its vision for change in terms of work ethic and behaviour of staff, and culture and structure. In other words, we considered whether people have been empowered to actually achieve the envisaged change.

In order to manage and communicate about a change process, the organisation must have a rationale that appeals to all concerned on the shop floor. The change initiators usually have such a rationale in mind, but they rarely state it explicitly. This makes it difficult to determine whether the reason given for the change makes sense. The rationale behind ongoing changes can be worked out using simple open questions, such as Why make the change? What is to be changed? For what purpose? How? Who? When and where? These questions are also useful when updating the rationale. After all, change is a dynamic process. It forces the organisation to continuously to discuss its rationale and keep it up to date during the change process.

Willingness

Willingness is the second element in our model. It concerns the way in which people talk about change and how they feel about the plans and procedures. In other words, willingness says something about people's

motivation to ensure that change is successfully achieved. According to Kotter (1997), people do not change because they are confronted with certain facts, but because of the feelings evoked by these facts. It is also important to consider what potential resistance to change may be based on. Heifetz, Grashow and Linsky (2009) point out that many failed changes are attributable to loss aversion rather than aversion to change as such.

In our study we looked at whether the upper and lower currents of the organisation complement each other. The formal part of the organisation consists of a set of organisation charts, job descriptions, hierarchical lines and procedures, i.e. the organisation as set out on paper. The reality as experienced by the people within the organisation is often very different, however. The informal organisation is based on social relations and shared perspectives. There are countless informal networks made up of varying sizes of groups of people who have a specific shared reality. The way in which people operating in these networks discuss change determines the context in which the change initiative or intervention has to be implemented. All the formal actions, interventions, communication bulletins and sessions that are part of a process of change can be considered the upper current of the change. The question then is how these actions and interventions are interpreted in the place where the change needs to be achieved. In other words, what are people saying in the corridors and at the water cooler? This is what we refer to as the lower current.

Implementation

Implementation is the third element in our model. It is defined as the actual actions of those concerned, the activities and interventions that are used in order to achieve the specific change. This may include temporary projects as part of the change process and changes in people's day-to-day activities. The following questions are relevant in this context. Which aspects of the change initiative have made a lasting impression? How are staff involved in the change process? Who has the initiative?

Reflective learning

Reflective learning forms the fourth element we looked at in the context of capacity for change. It is important that organisations learn from their experiences with change. By learning, we mean the ability to identify and rectify mistakes and impediments (i.e. enhance effectiveness) and the ability to discover new perspectives and apply them in change processes.

Change is often a process of seeking out what works and what does not, and in the latter case going back to the drawing board. No matter how well thought out a change process may be, the results should be constantly scrutinised in order to check whether they meet expectations and modifications should be made where necessary (Ten Have et al., 2013).

The challenge is to work out what is at the root of undesirable effects (e.g. side effects) of the change process and to stop repeating the same knee-jerk reaction. The deeper the learning, the longer-lasting the learning effect. Reflective learning can have implications, for example, for the implementation (modifications) or for the adjustment of the vision of change.

The theory on double-loop learning (Argyris & Schön, 1974) proved a valuable addition and led us to consider the effects we had as supervisors. In double-loop learning, the frameworks in which one operates are considered and adjusted where necessary. The idea behind this is that if one continues to do what he or she has always done, one will continue to achieve the same results (single-loop learning). In order to reach new results, it may be necessary to reflect and reframe the problem (double-loop learning). Imagining yourself in a situation in which you are in a similar position, without making any value judgements, and investigating what could be done differently (including what you could do differently yourself) can be a very useful exercise (Wouterson & Bouwman, 2010).

Tools

In every stage of our research, we applied various tools at different moments and used several observers. With regard to 'conversion of vision', for instance, we developed a change rationale to identify whether the organisation had a clear narrative as to the who, where, how, what, why and wherefore and as to when the change would take place. We also made use of the All Quadrants All Levels system developed by Wilber (1996). This tool provides a good picture of the different types of efforts made by an organisation in the context of a process of change. Is it an all-encompassing process or does the organisation approach the process in a very one-sided way? For example, does it only tackle processes and systems, and leave behaviour, culture or intentions out of the equation? And is this appropriate given the change brief?

To learn about the elements 'willingness' and 'implementation', we made use of the success rate indicator, which is a questionnaire that we distributed among the organisation's staff. The questionnaire covers the necessity, the ambition and the implementation of the change. It also distinguishes between the upper current and the lower current in the change process. This tool allowed us to gain a broad picture of how the change process is implemented at the organisation and of the attitude towards the change. The responses to the open questions put a different complexion on the concerns that exist among the organisation's staff.

The analyses and surveys also enabled us to ask targeted questions during the interviews. Before conducting interviews, we explained that we would ensure the data we used would not be traceable. Conducting interviews is a crucial step. The interviews with staff showed us what really inspired people, what had been achieved, what people's concerns were and whether attention was waning.

9.6 Risk assessment – what did we see?

The common themes of our findings are described below. Not all of our findings apply to each organisation that took part in the study, let alone all organisations in the financial sector. Our findings give an impression of what we frequently encountered and provide pointers for a follow-up.

Genuine willingness to change

A common theme that emerged is that staff at all levels are very willing to change, which is particularly striking given the difficult economic context.

We spoke to people who felt strongly committed to the need for the changes (e.g. the simplification of products and services) we looked at in this study. Most people we interviewed were positive about the changes that have been made, particularly when those changes required them to use their professional expertise.

This sense of positivity is reinforced when the changes start to bear fruit. People derive satisfaction from the fact that they were getting positive feedback from customers again or that they had something positive to say about work to their friends. By supporting change and inspiring their staff, the people at the top of the organisation demonstrated a willingness to change.

Widely shared sense of urgency

Organisations are aware of the need for change, partly because they need to ensure their own survival, and partly because some things simply require improvement. Moreover, the organisations that we looked at were aware of the need to become more innovative so that they would be less likely to be taken by surprise and were better able to respond to future changes.

Management boards and other senior management also express this sense of urgency and encourage their staff to feel it too. We also saw that management is able to capitalise on this sense of urgency and the willingness to change. As a result, management can put all its energy towards introducing changes and staff are more than willing to accept the painful or difficult aspects of the change process as well (e.g. job losses).

Priorities not sufficiently clear

Sometimes the choices made are insufficiently clear, as a result of which people are assigned more and more work, often requiring them to work overtime.

In addition, staff members generally find that they are unable to get to the crux of the change owing to regulatory burdens and the systems they currently have to work with. Even when clear decisions are made, management often enforces them insufficiently and they are not adequately checked against the actual situation (i.e. what they mean for people on the shop floor). As a result, people on the shop floor are given the freedom to stick to familiar patterns, and no real change is made.

Anchoring change

The greatest challenge is to keep the envisaged effects in mind and to anchor change through genuinely different behaviour. While the vision is often translated into objectives, little attention is paid to translating these objectives into specific forms of desirable behaviour. All change processes essentially come down to the same thing: are people able to change their behaviour? Moreover, little attention is paid to what the envisaged change means for the organisation's culture.

We found that changes are often initially approached from an instrumental perspective, i.e. via systems, processes and procedures. Although the majority of organisations understand that such an instrumental approach is not enough to achieve lasting changes in behaviour, they are not putting much effort into those aspects that are vital for achieving and guaranteeing lasting change.

When organisations fail to anchor changes properly in their culture, there is a risk of them reverting to their old behaviour and habits. People continue to behave in the way they did before, as they are not given sufficient coaching in the desired behaviour and are not held sufficiently to account. Or they revert to their old ways as changes are too long in coming, and not enough time is taken to enable new forms of desirable behaviour to become engrained.

Insufficient time and space for reflection

Although they are very willing to learn, during change processes organisations pay little attention to how things are proceeding, what works and what does not. There is not enough time for reflection, and when there is, people find it difficult to do it properly.

As a consequence, working methods that have been used successfully elsewhere in the organisation are not sufficiently used as a learning tool. People do not have any time at all for reflection at a deeper level, such as thinking about whether the adopted leadership style is effective in the current phase of the change processes and whether it is in keeping with the motives of management.

Organisations that take the time for reflection often focus very much on content, rather than on emotions and behaviour during the change process. When plans and working methods are adjusted during the course of the change process, this is usually unintentional and is considered to be a necessary evil (such as departing from the plan) rather than an effective intervention.

In addition, we found that those at the top of the organisation, middle management and the 'originators' do not seek out different or dissenting opinions. Disappointments and actions that need to be abandoned are not discussed either. In fact, we were struck by the fact that the bearers of change want to persuade people who hold different opinions that making the change is the right thing to do. The bearers of change are unaware of this pitfall and often believe that they are in fact organising dissension.

Reflective learning has proved to be a challenge at many organisations. Given the context described above, there are few people who have time for reflection. However, it is still necessary to ask questions, such as whether the organisation is doing the right things, whether what it is doing is in keeping with its values, and what factors lead to either failure or success.

Leadership plays a decisive role

Although leadership in itself is not the subject of the study by AFM and DNB, the importance and role of leadership emerges in all studies. We found many strong, knowledgeable and committed managers at the top of organisations. They play a crucial role when it comes to enhancing willingness to change among staff. These people at the top of the organisation are responsible for the change process and play a key role as a source of inspiration. Another positive aspect is that management can get the organisation moving. There is also a great deal of openness and willingness among management when it comes to discussing this subject and helping to find solutions. This shows how important it is that the type of leadership is appropriate to the envisaged change. Thinking about this issue in detail, establishing leadership profiles or leadership models, and focusing on leadership by measuring the performance of managers in this area and obtaining feedback can go a long way towards helping to enhance the capacity for change (Ten Have et al., 2009).

During our interviews, we found that there are still many gains to achieve in this area. Overall, we observed a lack of diversity in leadership styles. During the various stages of the change process, the required leadership style is not consciously considered. The preferred style is a results-based form of leadership that resembles crisis management. Another common form of leadership we encountered was one based on more technical aspects. These are all good qualities to have in the initial stage of a change process. However, we did not come across anywhere near as many leaders who have a natural feel for fine-tuning and who are able to implement change throughout every part of an organisation. Another striking finding

is that top management is often very involved at the beginning of a change process, but not at all in implementing or anchoring change. It is crucial for top managers to remain involved until the end of the process, make connections, listen, and make adjustments where necessary. We saw relatively few effective people managers and motivators who could adequately explain to their staff how the change would affect them.

Adaptive leadership is characterised by observing events and patterns, interpreting those findings based on various hypotheses, and drawing on these hypotheses to come up with interventions that can influence events. This calls for an iterative process, which requires self-reflection in order to be successful (Heifetz et al., 2009). In our study we found that management and middle management are not always able to link the vision at the top of the organisation to the often small successes achieved by people on the shop floor.

As a result, opportunities to show the organisation that it is on the right track, which can create positive energy, are missed. Middle managers have to act as the link between the people on the shop floor and those at the top of the organisation. This means that in addition to having to deal with their daily workload, they are also required to transpose the vision underlying the changes and ensure that the vision for change is translated into behaviour, that staff contribute ideas and genuinely change, and that success is achieved. Middle management therefore has an important and difficult job to do when it comes to ensuring successful change. Not only do middle managers need to receive better support from top management, but they should also receive recognition for the major challenges they are facing.

Forming an opinion

After studying various issues using various tools, we looked for patterns and common themes. The findings were refined in challenging dialogues with our experts and account supervisors. In dialogue with the organisations,

we looked at how to correctly interpret our findings. We asked the staff concerned (from the organisation's HRM or Compliance department) whether the analysis resonated with them, and at a later stage we asked the same question to the organisation's management. Questions such as Does this strike a chord with you? Which aspects do you agree with most, and which do you agree with least? Can it be improved? What do you require in order to address this? proved crucial in the first interviews.

9.7 Risk mitigation – what do we expect?

All in all, the studies performed over the past two years produce a mixed picture. In our view, the research leads to the following expectations regarding supervisory authorities and the sector.

DNB and AFM have deliberately opted for the role of encouraging the required change. To this end, in the next few years we will continue to invest in our own knowledge of the capacity for change within organisations. A central expectation is that there is a clear opportunity for change agents at the organisations. They can be found in all echelons and layers of the organisation. They can take on a facilitating role by initiating a dialogue on factors that impede the capacity for change, and by looking for potential ways in which the organisation can improve. Given the complex nature of change management, it should not become a box-ticking exercise. It is not enough to translate impediments into guidance, procedures and the like.

Change agents could ask the following questions: how can we ensure that we take the time and the opportunity to learn from change? What exactly do we want from staff in terms of desired behaviour? How can we ensure that we not only embark energetically on the change process, but also have the right people for implementing and anchoring change? What do people need in order for the change process to succeed? Is there enough change expertise available at the top of the organisation?

We also noted that most of the organisations we visited are still fully preoccupied with themselves, putting their house in order, working on their systems and developing the right culture. Their focus is inward-looking, but in order to achieve their goals and become sustainable, customer-focused organisations, they need to focus on the wider environment and on their customers, and bring in external stakeholders. We would like to see change agents contribute in this area by facilitating stakeholder feedback.

A third expectation is that organising reflective learning is crucial to change capacity of organisations. While this is in itself unsurprising, given the context it is important to pay attention to this matter in order for the change task for the entire sector to succeed. To ensure that organisations remain capable of responding to changing circumstances, we will in any event continue to ask that they pay attention to anchoring the changes in culture and behaviour at the organisation. We expect senior management to be willing to change and be capable of self-reflection.

Conclusions and reflections for supervision

After our inspections the organisations started to put our findings to use and are keeping supervision informed about their progress. As a result, further discussions about the changes have been initiated at various organisations, while other organisations have made more practical

adjustments that were in keeping with existing initiatives. The experience gained has also been incorporated into training courses, or considered choices have been made in relation to change initiatives. When it comes to solutions, there is no one size that fits all, and this is no less true for supervisory authorities. It is therefore necessary to determine what an organisation needs to do on a case-by-case basis.

Given the importance of the required change process, it is essential for the sector that there is sufficient capacity for change. AFM and DNB will therefore continue to monitor the sector to ensure that it develops sufficient capacity for change. More specific, we are confident that this instrument helps embedding the desired changes in the financial sector. Based on our experience in the thematic review, we think it is essential for supervisory authorities to continue to be aware of the dilemmas that are inherent in supervising capacity for change. Helping to enhance capacity for change is more important than identifying weaknesses. This means that there needs to be transparency concerning the design and objectives of research into capacity for change, and useful, comprehensive feedback regarding the results.

Dilemmas facing the supervisory authority

It is important to bear in mind that this also creates dilemmas for the supervisory authority. Capacity for change is not something that can be imposed or enforced by the supervisory authority. The extent to which parties were willing to participate in the study was greater than initially anticipated. We can attribute this to an inherent willingness to change and to the fact that we were very explicit about the purpose and structure of the study before we began. It was clear from the start that no enforcement actions would ensue. Supervisory authorities play multiple roles, and in our study we decided on an advisory and motivating role. We wanted to encourage the organisations to learn. We also spent a great deal of time with people working for the organisations that took part in the study, for example when deciding on topics and when performing analyses.

That said, there is one role that the supervisory authority always has, irrespective of the circumstances. Supervision imposes obligations, and organisations are expected to make serious efforts to put the study's recommendations into practice. We will return and perform follow-up studies to find out what organisation did with our recommendations. To this end, we have developed indicators based on attitude (the organisation is open to addressing impediments and success factors), knowledge (understanding of impediments and success factors) and behaviour (specific action to improve capacity for change). Moreover, if, in practice, there is insufficient capacity for change, the envisaged results will not be achieved either; as a consequence, it may be necessary to introduce alternative supervisory measures.

Having spent more than two years researching capacity for change, AFM and DNB conclude that supervision in this area plays a crucial role in promoting desirable developments within the financial sector. Change supervision should not replace regular supervision, nor should it be performed in the same way. Instead, it should be based on the perspective that, when it comes to ensuring sustainable change, in addition to considering outward manifestations it is especially important to look at the ability of organisations to organise, implement and anchor change.

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1



Culture Change

10.1 Introduction

This chapter elaborates on DNB's supervision of culture change within financial institutions. We will address several questions: How do we execute the supervision cycle, risk identification, risk assessment and risk mitigation, in this regard? Where do we focus our attention? What do we see during our inspections? And what do we expect of financial institutions when it comes to culture change?

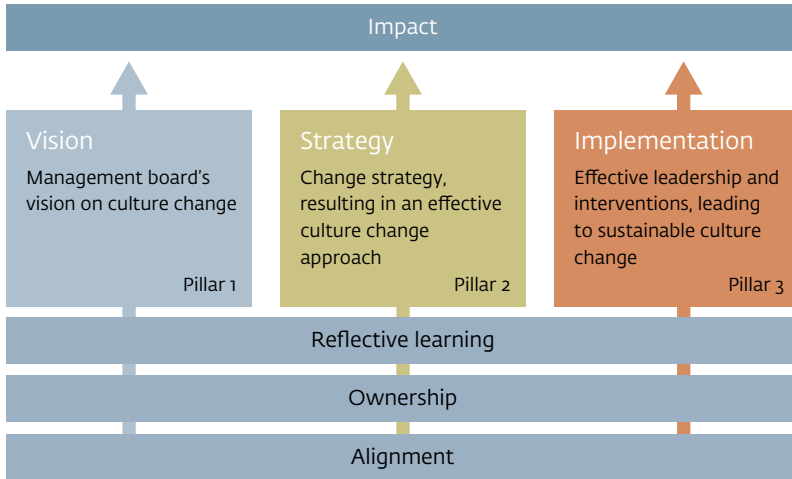
We will start by exploring our supervisory model on culture change. Central to this model are the three pillars, Vision, Strategy and Implementation, as discussed in section 10.2. Section 10.3 elaborates on the three key criteria of Reflective learning, Ownership and Alignment, which apply to every pillar. Section 10.4 reviews the focal points of our supervisory inspections, explaining how we identify the risks to sustainable effectiveness of planned culture change. Next, section 10.5 describes two cases that illustrate risks in culture change practice that we encounter in the financial sector. Finally, this chapter concludes with section 10.6, detailing our expectations of financial institutions regarding culture change.

10.2 Supervision model on culture change

The goal of DNB's supervisory approach to culture change at financial institutions involves mitigating risks that impede sustainable effectiveness of a planned culture change. Our supervisory inspections help us determine

the potential effectiveness and sustainability of a planned culture change, using the assessment framework described in this section.

Figure 10.1 Three pillars in the supervision of culture change



The three pillars

Central to the assessment framework are three pillars: Vision, Strategy and Implementation. Three pillars might suggest a model based on linearity. Yet in reality, forming a change vision and strategy as well as implementing change interventions influence reciprocally (De Caluwé & Vermaak, 2003). We adopt a more fluid perspective and assume these pillars work parallel to each other. This means that when a financial institution is 'running' a planned culture change, we still assess the underlying vision and change strategy and approach these steps with an open view.

1. Vision

The Vision pillar identifies the direction of the culture change and the related assumptions. It focuses on the management board's assumptions concerning:

- Organisational culture what is organisational culture, why is it important and what role does it play in the institution?
- The reason why the culture should change – is a new strategy involved, a deterioration in market conditions or perhaps integrity incidents?
- What exactly should change and how – does the culture change require new organisational beliefs and values or is it mainly to change specific behaviour, such as increasing customer focus?

The explicitation of these assumptions by the management board results in building blocks of a strategic change narrative that explains the rationale (including the 'what and why') of the culture change.

2. Strategy

The Strategy pillar considers how the vision on the culture change is translated into a change strategy. The explicitation of assumptions in the first pillar results in a strategic change narrative. Based on these assumptions and the narrative on 'what and why', choices can be made about the 'how and who' of the culture change and result in an approach to the change process. Therefore, this second pillar focuses on how the results of pillar 1, the assumptions and the change narrative, are translated into a change strategy. We expect this strategy to address:

- The dominant approach: is this strategy based on changing the culture using a blueprint, is it considered an organic development or is it a more cascaded change approach?
- The interventions: what are important levers needed for the culture change? How broad and deep are the chosen interventions?

It should be noted that this supervisory model, and in particular the first two pillars, explicitate what we expect of the management board in their leadership of the culture change. We focus on the role of the management board because the way the culture change is handled by the executive management is crucial for bringing about a sustainable and effective culture change (see Chapters 2 and 5 of this book; Cummings & Worley, 2005).

3. Implementation

The Implementation pillar focuses on the execution of the planned culture change. Are the plans working? Are the people able to actually change their behaviour and group dynamics? Are the interventions leading to the desired behavioural and cultural change? Here the focus is on:

- The effects of leadership, how do employees at an operational level experience the change? Are they involved and do they feel that things are going differently?
- The effects of the interventions, which levers are effective and which are not? What behavioural and cultural changes are being achieved?

Impact

Impact takes a prominent position in our supervisory model of culture change. We think it is important that the intentions and activities of the institution concerning the culture change lead to results. For instance, a change narrative is a result of the efforts of the management board in pillar 1. The most important illustration of the impact is that the change vision, strategy and implementation lead to sustainable changes and effects in behaviour, group dynamics and mindset. Do the change interventions impact the organisation? This is an overarching question and is relevant for supervision at all times during the change. Furthermore, we expect that the impact of the activities and interventions in the pillars are closely, and as concretely as possible, monitored by the management board during the culture change.

10.3 Key criteria

In this section, we would like to elaborate on the key criteria that apply to the three pillars. In our supervisory framework, each pillar has several core elements that are assessed based on three central key criteria: Reflective learning, Ownership and Alignment. In addition to these three key criteria, every pillar has a number of specific criteria. This section discusses the three key criteria that apply to each pillar, while the next section on risk identification explains specific criteria for each pillar in more detail.

Key criterion 1. Reflective learning

Change is often a process of exploring what works and what does not work and, when something isn't working, going back to the drawing board. No matter how well thought out a change process may be, the results should be constantly scrutinised in order to check whether expectations are met and whether necessary modifications should be made (Ten Have et al., 2012).

Reflective learning is the ability to identify and rectify mistakes and impediments (i.e. enhance effectiveness) and to learn from them and adjust change interventions, if necessary. On a deeper psychological level, it is the ability to 'stop and think', critically reflecting on your own assumptions and actions. The aim is to discover new perspectives and apply them in the change processes. It is closely related to the notion of double-loop learning or second order change (Argyris & Schön, 1996), which challenges existing assumptions and beliefs.¹

As we explained in Chapter 9, it is our experience that financial institutions are willing to learn, but pay little attention to how things are proceeding: what works and what does not. There is not enough time for reflection, and when there is, people find it difficult to focus on the how (and not

¹ See Chapter 9 for a more extensive discussion of this aspect

the content or the what). As a consequence, working methods that have been used successfully elsewhere in the organisation are not sufficiently deployed as a learning tool. This implies the risk that organisations will learn little from mistakes or other shortcomings and will not do enough to prevent them.

The term reflective learning is closely related to reflexivity. West (1996) identified team reflexivity as an important determinant of team effectiveness. Team reflexivity is defined as the extent to which team members collectively and openly discuss their objective and process, develop strategies, and plan to adapt these aspects to current or anticipated circumstances and make changes accordingly (Carter & West, 1998; Swift & West, 1998). Non-reflexive teams show little awareness of the team objective, strategies, the environment in which they operate, and the well-being of their members. Reflexive teams ensure more detailed planning, pay more attention to long-term consequences, have a larger inventory of environmental cues to which they respond, provide more support to members and reflect more on how conflicts are resolved as well as the overall social climate of the team.

Key criterion 2. Ownership

We consider ownership of the management board crucial to the success of the culture change. The central question for supervision is whether the management board is involved and shows that it has a personal stake in changing the culture and, ultimately, in the performance of the organisation.

A lack of ownership is basically the absence of leading by example or role modelling. As stated in Chapter 6 on leadership, a key feature of role modelling is the congruence of leaders' visible behaviour with their inner values. The more congruent leaders' behaviour is with the inner beliefs on the culture change, the more employees are clear about what they should do, think and value. Inconsistencies between leaders' values and

their behaviour can have significant and long-lasting effects. It can create an organisation that is distracted, because the direction in which the organisation should be headed is fuzzy or absent (see Ten Have et al., 2012). An adequate focus helps people make the transition from realising that something must be done, to taking concrete action. This transition can only be made if the exemplary behaviour of the management board guides employees' behaviour in a concrete and visible manner.

Key criterion 3. Alignment

Alignment between organisational culture and the rest of the organisation, for example strategy, governance, ICT systems and leadership, is a well-known concept in the literature. Chatman and Cha (2003) refer to the importance of leveraging culture and ensuring that culture is strategically relevant. They clarify that culture is crucial to performance because it shapes and coordinates employees' behaviour. Moreover, culture works as a correcting force, since it clarifies to employees what is important and focuses their attention on organisational priorities that guide behaviour. An effective culture (change) is therefore related to business strategy (Chatman & Cha, 2003, p.21). Culture empowers employees to think and act on their own in pursuit of strategic objectives, increasing commitment to those goals (O'Reilly & Chatman, 1986).

In our supervisory framework, alignment between the pillars is important. In order for changes to be successfully implemented, linkage and alignment between the aspects of a change model are necessary (see Ten Have et al, 2012). But alignment within the pillars is also crucial. We will elaborate further on this in the section on risk identification.

The development of two different realities within the organisation increases the risk of non-alignment (Daft, Murphy & Willmott, 2010). There may, for example, be a formal reality based on ideas and assumptions from a select group working on the change initiative, which is written on paper, spreadsheets or PowerPoint slides. This reality is focused on

changing structures or roles and responsibilities. Meanwhile, there may also be an informal reality based on the current behaviours and their drivers, which is not impacted by the changes in the formal organisation. A lack of alignment between strategy and culture can mean that employees do not understand the strategic goals of their organisation and how their behaviour, what they do and decide every day, impacts the achievement of these organisational goals. Instead, employees provide their own explanations and sense-making concerning changes and key events (such as a restructuring or lay-offs), which can lead to disagreement and conflicts concerning priorities or an unwillingness to go the extra mile to deliver on strategic objectives (Chatman et al., 2003).

10.4 Risk identification – What are our points of interest?

This section discusses where we focus in our supervisory inspections of culture change. We describe our focal points for each pillar, the key elements and the key criteria we use to identify risks.

1. Vision

Focus

The focus of DNB's supervision of the first pillar is to identify risks to effective culture change resulting from the management board's work on the change vision. We focus on if and how the management board explores its assumptions on culture change, and what choices the board makes concerning what needs to change and why. We study whether this work results in a clear and compelling vision on culture change.

Key elements

Within the first pillar, Vision, we identify risks by focusing on three key elements:

I. Vision on culture

Collective vision on organisational culture, including a definition of organisational culture and a model that clarifies the vision. This vision relates to the 'what' of the culture change. For supervision, it is relevant to consider which choices the management board makes here and why.

II. Vision on culture change

Collective vision on changing culture of this specific institution. This vision concerns the 'how' of culture change. The management board creates a vision on influencing culture and changing human behaviour.

III. Change narrative

The change narrative summarises the assumptions and choices made by the management board. It details what has to change and why this is necessary. It is a narrative that appeals to employees, connects them and creates movement.

In summary, creating a collective vision on culture (I) and culture change (II) is an essential first step to create a vision on culture change within the financial institution in question. This is translated into a change narrative (III) the management board uses in its communication about the culture change, primarily to the organisation itself and secondarily to other stakeholders such as clients, shareholders and regulators.

Criteria for assessment of Vision – pillar 1.

The following table gives an overview of the criteria we use to assess the Vision pillar.

Key criteria

Reflective learning

The management board is expected to conduct a board dialogue in which it explores the individual assumptions and beliefs on culture and culture change. The level of reflectiveness on the members' own beliefs will enhance the quality of this dialogue, resulting in a collectively shared narrative on the culture change.

Ownership

The fundamental choices underlying the strategic change narrative fall under the responsibility and ownership of the management board.

Alignment

The alignment between organisational culture and the rest of the organisation, for example, strategy, governance, ICT systems and leadership, is an important criterion to assess.

Specific criteria

- Quality of the vision on culture
- Quality of the vision on culture change
- Quality of the change narrative

2. Strategy

Focus

The focus of DNB's supervision of the second pillar involves identifying risks to effective culture change, resulting from the translation of the change vision into a change strategy. Here we focus on the change approach, including the design of a culture change programme, project or initiative. The results of pillar 1, the vision of the management board on culture change summarised and illustrated by a change narrative, are translated into an approach and change strategy.

Key elements

Within the second pillar, Strategy, we identify risks by focusing on two key elements:

I. Change strategy and approach

The change strategy is the way the financial institution changes its culture. We assess the extent to which the change strategy is aligned with the macro-economic context, the rest of the organisation and the change history of the organisation. The approach or design needs to be realistic in terms of goals and planning, and clarify effect measurement.

II. Interventions

The interventions are part of the design of the planned culture change. The chosen interventions show what action will be taken and what handholds will be used to evoke change. We assess the extent to which interventions are multi-dimensional: whether they intervene in multiple aspects (such as the way people work together and the way a workflow is set up). We assess the extent to which the interventions aim to change behaviour and culture on several levels: behaviour, dynamics and/or mindset. This concerns the depth the interventions are aiming to reach concerning culture change.

Criteria for assessment of Strategy – pillar 2.

The following table gives an overview of the criteria we use to assess the Strategy pillar.

Key criteria

Reflective learning

The level of reflectiveness and ability to question choices made during the development of the approach will enhance the quality of the change strategy.

Ownership

The management board owns the translation of the choices that resulted from the work in pillar 1 to a plan or strategy. At this stage, the management board is leading the process or it may have delegated the translation of the results of pillar 1 to, for example, the HR organisation or an external consultant.

Alignment

The alignment between the strategy and the versatility of the planned interventions.

Specific criteria

- Quality of change strategy and approach
- Quality of interventions

3. Implementation

Focus

The focus of DNB's supervision of the second pillar is to identify risks to effective culture change resulting from the implementation of the change strategy and approach. During implementation we focus, among other things, on the effects of the interventions in terms of behavioural and cultural change.

Key elements

Within the third pillar, Strategy, we identify risks by focusing on two key elements:

I. Leadership of the culture change

Leaders of the organisation show exemplary behaviour. We assess the extent to which management is willing and able to create a climate of psychological safety, which allows employees to learn from their mistakes and grow.

II. Behavioural and culture change

The proof of the pudding is in the eating: now it becomes clear whether the interventions as part of the change strategy are reaching different parts and levels of the organisation. We focus on whether interventions are having tangible or less tangible effects on behavioural change, change at group level (within and between groups) and change in mindset.

Criteria for assessment of Implementation – pillar 3.

The following table gives an overview of the criteria we use to assess the Implementation pillar.

Key criteria

Reflective learning

The management board keeps track of the progress of the change process and adjusts its course along the way.

Ownership

The management board shows ownership through role modelling and identifies openly with the culture change and the anticipated impact on the organisation.

Alignment

The alignment concerns the upper current and undercurrent.²

Specific criteria

- Quality of leadership of change
- Actual behavioural and cultural change

² As stated in Chapter 9 we make a distinction between the upper and undercurrent within organisations. The upper current, or the formal part of the organisation, consists of a set of organisational charts, job descriptions, hierarchical lines and procedures, i.e. the organisation as set out on paper. The undercurrent is the reality as experienced by the people within the organisation and how change interventions are interpreted in the area where the change needs to be achieved.

Figure 10.2 gives an overview of the pillars, key elements and criteria

Pillar	Key elements	Criteria
In general		<ol style="list-style-type: none"> 1. Alignment 2. Ownership 3. Reflexivity 4. Impact
<p>Vision</p> <p>MB's vision on culture change, resulting in fundamental assumptions.</p>	<ol style="list-style-type: none"> 1. Collective vision on culture 2. Collective of vision on changing the culture 3. Change narrative 	<ol style="list-style-type: none"> 1. Quality of vision on culture 2. Quality of vision on culture change 3. Quality of change narrative 4. Alignment 5. Ownership 6. Reflexivity 7. Impact
<p>Strategy</p> <p>Change strategy, resulting in a design of the culture change approach: focus on sustainable change levers.</p>	<ol style="list-style-type: none"> 1. Change strategy and approach 2. Interventions 	<ol style="list-style-type: none"> 1. Quality of change strategy 2. Quality of interventions change 3. Alignment 4. Ownership 5. Reflexivity 6. Impact
<p>Implementation</p> <p>Multiple interventions, leading to sustainable culture</p>	<ol style="list-style-type: none"> 1. Leadership of culture change 2. Effects of interventions 	<ol style="list-style-type: none"> 1. Quality of leadership of change 2. Behavioural and cultural change 3. Alignment 4. Ownership 5. Reflexivity 6. Impact

10.5 Risk assessment – what do we see?

The risk assessment of the supervision cycle focuses on what DNB actually sees during inspections and the risks these observations may entail. In order to enhance the readability of this chapter, we have maintained the sequence of the indicators mentioned in the previous section when giving examples and associated risks. Note that these examples are not exhaustive and are only used to illustrate the three pillars. However, before giving examples of each indicator, we share a general observation.

From our experience as supervisors of behaviour and culture in the financial sector, we see that financial institutions try to change behaviour and culture mainly through altering strategy and structure. Moreover, institutions apparently think that by changing structure, behavioural change evolves naturally. Changing behaviour and culture is a blind spot in the financial sector and consequently, an important focus of DNB's supervision of behaviour and culture. This is even more so because of the strategic impact and the risks involved whenever behaviour and culture changes fail. The case discussed in the box below is illustrative of a focus on change in strategy and structure, and a lack of attention for the behavioural change that is needed.

Organisation X needs to realise a complex integral transformation process. The organisation strongly emphasises the financial and process changes and hardly touches upon the behavioural change that is required for this transformation. This, while the behavioural and cultural change is crucial to the successful realisation of the organisation's strategy and future solidity, as it too has stated.

Our assessment reveals that in the change Vision, Strategy and Implementation, very little attention is paid to the major psychological turnaround employees of organisation X must make. This leads to all kinds of tension, negative emotions and resistance. There is, for instance, a mourning of the loss of the old situation: an important market is shrinking and the market share is dropping sharply, employees are losing their jobs, their job security and the colleagues they have been working with for years. Simultaneously, organisation X is making a strong appeal to its employees to help the integral transformation process to succeed. Employees are not sure of their jobs in the new situation. That evokes feelings of insecurity and anxiety.

Achieving a psychological turnaround of the employees requires attention and orchestration from the management. Our assessment showed that managers were not sufficiently able to recognise and handle this psychological turnaround. Nor did the managers receive any guidance or direction in this from their superiors.

In the case of organisation X, the lack of attention to and guidance in the psychological turnaround that the organisational transformation asks of its employees risks an ineffective emotional reaction – or undercurrent – to the change process. The risk of disregarding this undercurrent is that employees disconnect emotionally. They lack guidance in the change from old to new, and in what this change asks of them. Employees can't cope with the change and the result is that they maintain their old behaviour. This behaviour is seen as ineffective and client-unfriendly in the new organisation. So the necessary behavioural change, which is a crucial step in realising the organisational strategy, is not realised.

During our supervision of culture change in the financial sector, we observed the following three pitfalls in the way culture change is managed:

- a) the culture programme is often disaligned from the rest of the organisation such as strategy, governance and IT developments (a red flag in terms of alignment);
- b) the programme is overly delegated to a consultancy or to the HR department, with a lack of ownership by the management board;
- c) through one-sided interventions, such as introducing new corporate values only or just through workshops, disregarding the other two layers of the iceberg: group dynamics and behaviour. This creates the risk of disalignment with the day-to-day working practices.

These pitfalls are considered risks leading to unsustainable and ineffective culture change due to a lack of alignment, ownership or one-sided interventions. Next, we will elaborate on these three pitfalls.

Pitfall a: framing culture change as a culture programme.

Culture change is often referred to as culture initiative or culture programme. Even though we are convinced that organisational cultures can be intervened upon and changed, framing and positioning culture change as a programme suggests that this is easy to fix – you only need to follow the steps of the programme and the culture will change. As language plays an important role in sense-making, translating deeper beliefs and forming new behaviour, we pay attention to the exact words (or labels) organisations use to position their culture change. In this regard, we also encounter leaders that are aware of the impact of language and intuitively grasp the underlying notion that culture change does not fit into a programme. Or better yet, should not be fit into a programme, since this communicates the (perhaps unintended) message that culture is easy to change and misses the point of its complexity and leverage with other fundamental parts of the organisation such as strategy, governance and leadership.

Pitfall b: delegating ownership of the culture change.

The second pitfall we have observed in our supervision is an over-delegation of the culture change to the HR department. In such cases we see management boards delegating not only the management of a change programme but also the ownership of the culture change to the head of HR. We see organisations translating culture change into a set of HR practices, such as competence profiles, appraisal systems and culture workshops.

Pitfall c: using one-sided interventions.

Most culture changes within the financial sector concern the launch of (new) corporate values. Values such as integrity, client-oriented, quality-driven, transparency and so on. No one can find fault with these values. And that's the risk of it. When everybody agrees, how distinctive can they be and will they be? Since the goal of values is to explicate behavioural norms in order to direct appropriate behaviour and create a sense of shared identity, how can such general statements be effective? The programmes, just like high-level, abstract corporate values, are too distant from everyday practice and lack any potential to direct day-to-day-behaviours, especially ingrained habits.

Organisational cultures develop and change through consciously changing the core of culture, i.e. by formulating new common images or shared beliefs that constitute a new culture. These shared beliefs are expected to develop into new values and new behavioural solutions for daily situations and, in turn, support and reaffirm the new basic assumptions (see Chapter 3 of this book; Schein, 2010, Straathof, 2009). Actual behaviour is rooted in assumptions and cognitive schemes concerning the social environment and organisational effectiveness ('mindset', in our iceberg model) and its interaction with the specific situation or context (Tiggelaar, 2010). Therefore, changing an organisational culture means that change takes place at all layers of the iceberg: at the level of behaviour and behavioural patterns, group dynamics and mindset.

The case discussed in the box below illustrates a few of these pitfalls.

Organisation Y developed a new vision and is transforming its organisational structure while tackling a high-profile misconduct case. It concludes that the heart of the transformation is a change of culture, because the existing behaviour and culture is considered an important root cause of organization Y's current problematic situation. So it launches a culture programme that was designed and executed by the HR department. We believe this creates two red flags in terms of alignment and ownership, which become clear in the strategic change narrative and the design of the culture change.

An important finding during our inspection is that the strategic change narrative is unclear on the connection between the new vision and strategy, the restructuring and tackling the misconduct. Moreover, the fact that the current behaviour and culture is considered as the root cause is hardly addressed. The change narrative lacks alignment in terms of the future (how is the culture change related to the future – strategy, structure and goals – of organisation Y?) and to the past (how does the existing culture hinder organisation Y in reaching its strategic goal?).

In order to realise an effective culture change, it was crucial in the above case to align the culture change with the future vision and strategy of the organisation as a whole. When everyone is convinced that the culture change is needed because of the strategic course of the organisation, its effectiveness is enhanced. It must be clear to every employee: where is the organisation headed and what behaviour and culture are needed to get there?

Furthermore, the management board took almost no ownership of the culture change. Even though its members discussed and referred to the culture change on several occasions individually, they hardly spoke collectively about this important change. Nor did they reach a collective agreement on the assumptions and vision underlying the change narrative and design of the change strategy. Instead, they delegated this to the HR department, with the risk of losing credibility and the power to move people.

10.6 Risk mitigation – what do we expect?

In this section, we discuss the expectations financial institutions should meet concerning effective culture change and what improvements or risk mitigating actions we require. We will illustrate these expectations using the cases from the section on risk assessment. Finally, we will elaborate on the mitigation strategies we applied in these cases. The structure of this section follows the sequence of the three pillars.

Vision

As mentioned above, it is important that:

- a) board members act as primary owners of the culture change;
- b) have a shared vision on culture and culture change; and
- c) are able to translate their strategic choices into a compelling and clear change narrative.

The majority of the culture changes we have encountered in the financial sector are not aligned with the strategy of the organisation. Consequently, alignment is an important risk indicator in our supervision and an important focus during the mitigation phase of our inspections. An effective culture change has a consistent, clear and compelling change narrative. More specifically, we expect this narrative to:

- a) explain the reason and the urgency for the culture change,

- b) explain why this culture change is necessary in light of the future of the organisation, and
- c) explain what the organisation is currently doing to realise this culture change. In the second case described in the previous section there was also a lack of alignment and the culture change narrative did not meet our expectations.

During an initial meeting with the CEO, followed by a meeting with the complete management board, we communicated the following message:

We believe that the Board should deliver a more consistent and compelling change narrative than what it presented at that time. We have the following concerns about the current narrative:

- The reason and sense of urgency for the culture change are not consistent. The emphasis on the reason for the change is either presented as a solution to problems or as an opportunity to improve business processes. Meanwhile, the urgency is unevenly communicated. For instance, phrases such as “How can we make this better?” do not elicit a sense of urgency. These contrast with formulations where the need for change is strongly emphasised: “This must happen now!”
- The alignment to the future of Y is insufficiently clear. A clear alignment of the culture change with the future of the organisation contributes to the effectiveness of the change because everyone in the organisation is convinced that this change is needed. In other words, where is the organisation headed and what kind of behaviour is needed to get there? The current narrative remains unclear on this point.

- Y's commitment to achieving cultural change is not clear. A culture change can only be lasting when different interventions are used: social interventions should be combined with changes of a more structural nature, related to work processes and organisational structure, for instance. We think that the board's current change narrative is not clear on how the desired culture change will be achieved.

Strategy

The expectations for this pillar concern the change strategy or the design of the change process. More specifically, we expect the change interventions to be multi-dimensional (interventions that aim for social change and structural change) and multi-layered (impacting behaviour, group dynamics and mindset). As mentioned before, in this phase of the change process the board usually delegates (part of) the development of the strategy to the HR department or to external consultancy. In the supervision case of organisation Y, the board delegated the vision, strategy and implementation of the culture change to the HR department. This was another important concern to us that we communicated to the board. We required them to take back ownership by going through pillars 1 and 2, and drawing up the vision and strategy as a board.

Implementation

In this pillar, the expectations are centred around the effective management of the transition, with a specific focus on the alignment between the upper current and undercurrent. In the psychological transformation involved in the supervision case of organisation X, we focused on a better alignment between the upper (namely building a new organisation, based on a new strategy and business model) and the undercurrent (in this case, mourning what was lost and the uncertainty of the future).

We required the following:

- The change narrative must address the psychological transition the employees and management are being asked to undertake, and the implications of this for the change approach.
- The psychological transition must be phased and actively managed by the management. People must be able to mourn before they can build. The priority should go to the uncertainty affecting people. Therefore, any redundancies should be announced as soon as possible.
- A strategy is needed on how to develop from the current culture to the desired culture, specifically taking account of the psychological transformation.

As supervisor, we applied two different strategies in the above-mentioned cases during the mitigation phase of the inspection. In the case of organisation Y, where we required a more consistent and compelling change narrative, we had a challenging dialogue with the full management board and the supervisory board during two separate sessions. In these sessions, we spoke about the specific points with a particular focus on the engagement and ownership of the board. We repeated our message in a formal letter sent to the management and supervisory board.

We applied a different mitigation strategy in the case of organisation X, which had to address the psychological transition in their leadership and approach to the change process. We started the mitigation phase with storytelling instead of a briefing, and conducted a challenging dialogue on our findings and assessment. The stories that we presented were core themes that arose from the interviews and referred to the psychological state of the organisation. For example, one of the core themes was 'mourn and build', referring to the employees that were dealing with strong feelings of loss while having to focus on building a new organisation. Obviously, grieving and building are two very different psychological

states of mind. We presented these core themes by using quotes from the interviews and by putting several quotes on a slide. Thus, the story of that theme was told. By using quotes, we wanted to stay as close as possible to the language and expressions of the interviewees.

There are two reasons for using storytelling in our mitigation strategy. The first is that we wanted to stay as close as possible to the undercurrent in the organisation, and present the management with a realistic story about their organisation. Storytelling is often used as a change intervention (Gargiulo, 2005). The main application involves collecting the stories of the organisation in order to understand what is really going on in terms of the undercurrent. This does not necessarily have to be the same as the story the organisation tells through formal channels such as newsletters, the intranet or speeches by senior management. Indeed, this difference between upper and undercurrent was also the case at organisation Y. Management thought the new strategy was accepted, but our research showed that people were not yet ready to start something new. They struggled with the paradox of mourning and building, which impeded the implementation of the changes. The second reason for using storytelling as a mitigation strategy is that we wanted the management to become more engaged with the undercurrent and recognise the stories. Engagement and recognition will help management to align the change interventions to the undercurrent, thus making the change process more sustainable.

In conclusion, changing organisational culture paradoxically begins with stagnation (Boonstra, 2013). Stagnation here refers to reflecting on the deeply rooted assumptions and gaining a profound understanding of the processes that create and maintain the existing culture. Our supervision of culture change aims to contribute to that reflection and understanding. It requires that leaders develop a collective, thorough vision and strategy on the culture change, which must then be translated into interventions that lead to sustainable change in behaviours, group dynamics and mindset.

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Rationale for supervision on behaviour & culture

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Focus on Group Effectiveness

Supervisory Approach & Methodology

Focus on Change

Future Developments

Part III

Future Developments

Chapter 11-12



Error management in financial institutions

11.1 Introduction

In financial institutions, as in any business, errors occur. Investment decisions that led to financial disaster also led to the nationalisation of banks (Hoekstra & Frijns, 2014), and there are multiple examples of excessive risk taking with detrimental consequences as well as ill-managed conflicts of interest among bank board members that have made the headlines (IMF Global Stability Report, 2014; Williams & Conley, 2014).

In the financial services industry, as in many other industries and sectors, errors can have severe consequences. We have used the term 'error' in this chapter to refer to all kinds of unintended mistakes. These may range from experiments with undesired outcomes to severe mistakes (Frese, 1995; Van Dyck et al., 2010; Van Dyck et al.; 2005), e.g. from an investment decision based on expected returns that are not achieved, to typing in one zero to many in a calculation. Errors are by definition unintended and therefore exclude intentional misbehaviour, but they cannot be avoided completely. Not only do the consequences of errors in financial services affect the institutions' corporate and private clients, but also the institutions themselves. After all, negative outcomes and unfulfilled expectations due to errors affect organisational performance. In addition, the public's view of the financial industry suffers from these errors. Public trust in banks for example declines¹, which has a negative impact on the real economy (Jansen et al., 2013). This means that to

¹ www.financialtrustindex.org.

safeguard the interests of the different stakeholders, it is important that financial institutions manage their errors effectively. This makes error management in the financial services industry an important topic for supervisors. Through identifying, analysing and intervening in the way financial institutions handle and learn from errors, supervision influences these institutions' error management culture. This chapter aims to explain why supervisors should examine error management at financial institutions and which aspects of error management should be the focal points of this type of supervision.

11.2 Responding to errors

The current responses to errors made in the financial services industry primarily focus on communicating that action has been taken, and that errors are not tolerated. Such actions primarily target specific individuals involved in making the error, or at risk of making future errors. Three common responses are observed. First, financial institutions tend to blame and punish the employees that have erred (for instance, by terminating their employment), not only to demonstrate that they find this behaviour unacceptable, but also to signal their readiness to take action. Deutsche Bank for example fired four traders accused of manipulating Euribor and Libor. Although the said manipulation was intentional, and therefore indeed unacceptable, it is not clear whether this type of response is effective or accurately reflects the sequence of events leading up to illegal behaviour. Deutsche Bank was subsequently court-ordered to reinstate the traders as the court found that the bank did not have sufficient guidelines in place, did not control the process and had systems in place that fostered the illegal behaviour². By blaming and penalising the employees involved, the bank implied that simply removing a particular employee or group of employees

² As reported, for instance, by the Financial Times, 'Deutsche Bank traders wrongfully dismissed, court rules', www.ft.com, and by Bloomberg, 'Deutsche Bank loses appeals court ruling over fired traders', www.bloomberg.com.

should solve the issue and prevent future problems. The question of whether or how organisational features or practices may have facilitated or implicitly condoned such behaviour was not addressed. Thus, such actions implicitly communicate that the organisation is not to blame.

A second type of response to errors is to specify the criteria that individual workers should try to comply with, as a way of preventing errors from occurring in the future. A case in point is the introduction of a bankers' oath on proper conduct in the Netherlands³. In 2016, all bank employees in the Netherlands will be required to take this oath, whereby they pledge that they will operate with integrity and care, and in the interest of their clients. The introduction of the bankers' oath constitutes a concrete attempt by policymakers and branch organisations to explicitly communicate the norms for proper conduct to individual workers in the banking sector. The intention is that this will influence their behaviour. It is considered a strategy to restore public trust, and to prevent further errors from being made in the banking sector. Nevertheless, this response also targets individual workers as being primarily responsible for the prevention of future errors, without regard for the system that they are part of. Although at first glance the introduction of a bankers' oath can be seen as a system-level response to public concerns about the banking sector, it also sets up individual workers as targets for blame and punishment if errors occur in the future. Making the prevention of errors the responsibility of individual workers deflects blame from the organisation, and makes it less likely that dysfunctional practices or undesirable incentives will be identified or adapted at that level.

A third common response to prior errors made in the financial services industry is to more closely monitor the decisions and actions of individual workers. In fact, increasing control functions constitutes the typical response from banks. More attention is given to risk management,

³ Ministerial regulation oath for the financial sector, Dutch government, dated 31-01-2013.

and audit and compliance functions are strengthened, taking a more prominent position in decisions and business choices. Across different national and banking systems, the regulator and supervisors have responded to bank errors by increasing the extent and severity of regulations and sanctions, and conducting supervision of the financial sector with more dedication and conviction (Sparrow, 2013). These responses aim to rule out future errors. Again, while this seems to communicate the message that errors cannot be tolerated, the increase in regulation and controls is relatively removed from the organisational dynamics and systems in which these errors occurred. Imposing external controls in this way allows these organisations to remain relatively passive given that they refrain from scrutinising their day-to-day practices and fail to consider ways in which these may unwittingly contribute to the occurrence of errors.

In short, contrary to what may seem to be the case, the most common responses to errors made in the financial services industry do not prevent future problems. The individual workers who committed the error are blamed and held responsible, employees are warned that they must adhere to ethical guidelines and their work is more closely supervised. However, none of these responses targets the broader organisational structures and cultures that may tempt workers into faulty decisions, despite their individual commitment to ethical guidelines and intentions to comply with regulations. Indeed, errors are still being made in the financial services industry. In fact, it appears the number of reported incidents and undesired outcomes has not declined since 2008 (Cools & Winter, 2013; Williams & Conley, 2014). This raises the question whether and to what extent the financial sector is actually learning from its errors, despite efforts made.

This chapter focuses on insights from psychological research that supervisors can use to identify, analyse and guide error management at financial institutions. This is part of a broader research project⁴ in

4 The author has adapted these texts specifically for this chapter.

collaboration with Leiden University under academic supervision of Professor Naomi Ellemers that aims to clarify how banks can work to improve their organisational culture by linking psychological insights and knowledge with their practice. Productive handling of errors – resulting in fewer errors and better organisational performance – requires an approach at organisational level. Handling errors as individual shortcomings alone, and thus blaming the error maker or relying solely on an obligatory bankers' oath, means the organisation can avoid scrutinising its daily practices or implicit employee guidelines. This is unlikely to lead to the desired improvement. Results from empirical studies on organisational psychology show that at an organisational level, transparency and open communication about errors, as well as a focus on learning from them, result in major positive outcomes. This chapter will clarify this effect and explain how existing insights into handling organisational errors can improve supervision of the financial services industry. Earlier research has revealed the type of approach needed to improve an organisation's performance, i.e. a (high) error management culture, explained later on. Supervision of behaviour and culture uses this knowledge to actively improve the error management culture in financial institutions, thereby improving their organisational performance, decreasing the number of incidents and fostering public trust in the financial services industry. We argue that supervisors would do well to pay attention to the error management culture in financial institutions and offers some practical suggestions on how they can go about doing this.

11.3 Error management culture: an organisational approach to errors

Organisations differ in how they approach errors. We distinguish between different approaches, which can be organised along two orthogonal dimensions: the level of tolerance for errors, and the type of response (see Figure 11.1). The combination of possible responses along these two

dimensions thus characterises four different organisational approaches. A first approach is to assume that current regulations and guidelines should prevent the occurrence of errors (no tolerance of errors), and not to make any organisational-level changes when errors are made (passive response). The assumption that the possibility of errors has been ruled out (for instance, by increased external supervision) means no provision is made for when errors do occur. As a result, errors are denied or covered up and the organisation, its management, nor its employees do anything to learn from their mistakes or failure. Denying that errors may and do occur characterises this organisational approach. It does not acknowledge that errors are inevitable in professional life; instead, errors are simply not tolerated or accepted and therefore not talked about. Silencing errors in this way implies that the circumstances leading up to their occurrence are not scrutinised, and therefore nothing is learned from them. Thus, if the system is flawed, or if circumstances that were not anticipated in the standard guidelines repeat themselves, similar errors may continue to occur time after time.

A second organisational approach is – again – a passive response to errors, in combination with acceptance. As in the former approach, nothing is done or organised to evaluate errors and learn from them. However, contrary to the first approach, it is accepted that mistakes and failures happen. They are tolerated and seen as an inevitable aspect of reality. There is in fact sympathy for those who are involved in making the error, but no one takes action to use these experiences to make improvements.

As a third possibility, organisations may blame and penalise individual error makers. In this approach, errors are not tolerated and an active response follows in the form of penalising the individual or group of employees involved. Errors have severe consequences here. Instead of helping employees to prevent future errors, this type of approach primarily creates fear of the consequences for any individuals making errors. This makes it unsafe to talk about errors or to even acknowledge that errors have

occurred, let alone to evaluate them. As a result, this strategy actually stimulates the tendency to cover up errors, making it less likely that lessons are actually learned from them.

We therefore argue that the three different approaches outlined above result in suboptimal individual and organisational performance. When individuals are blamed and penalised, or when errors are covered up or ignored, nothing is done to examine and learn from them. This is different in the fourth and most productive approach, characterised as error management. When people communicate openly about errors and have the tendency to reveal them, when errors are quickly detected, analysed and corrected, and when knowledge of errors is shared in the organisation, this is referred to as an 'error management culture'⁵ (Rybowiak et al., 1999; Van Dyck et al., 2005). In such a culture, errors (contrary to intentional misbehaviour) are accepted as something that is an inevitable part of (professional) life. However, the tolerance of errors is combined with an active response and a clear ambition to learn from the errors that are made, so that ideally the same error is not made twice. This approach primarily views errors as an opportunity for organisational development and improvement, that one is obliged to take.

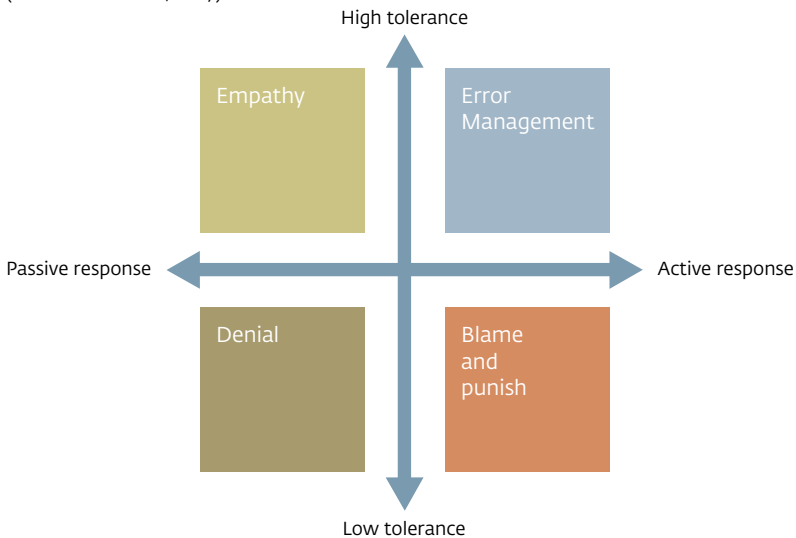
More systematic empirical evidence for these four organisational approaches to errors has been obtained from prior research on organisational error handling. Homsma (2007), for example, uses two dimensions in his analysis of organisational assumptions of errors: tolerance of errors and decisiveness towards errors. Van Dyck, et al. (2005) examined differences in error cultures in businesses using interview data. Results from this examination allowed the researchers to group organisational responses into four categories of approaches, as plotted

⁵ The literature distinguishes between the concepts of error management culture and error management climate. The main difference is that error management culture refers to organisational practices, while error management climate refers to people's perceptions of these practices. In this chapter, we use the term error management culture.

in Figure 11.1 below: error aversion or denial (not tolerating errors and responding passively), empathy (tolerating errors and responding passively), blame and punishment (not tolerating errors and responding actively) and error management culture (tolerating errors and responding actively).

Figure 11.1 Four organisational approaches to errors

(based on Homsma, 2007).



In short, based on prior work and the analysis above, we argue that an organisation with a high error management culture starts by acknowledging that errors are made and then responds actively by stimulating evaluation of the errors and organising means and practices to learn from them (Homsma, 2007). In the next section, we will elaborate on the positive effects of combining a tolerance of errors with the ambition to learn from them, and on the effect of error management culture on performance.

11.4 Error management culture improves organisational performance

The way an organisation handles errors is related to its financial performance. Research has shown that error management culture predicts the economic performance of an organisation (Baer & Frese, 2003; Edmondson, 1996; Frese, 1995; Homsma, 2007; Van Dyck et al., 2005). For instance, Van Dyck et al. (2005) studied the relationship between error management culture and organisational performance using a sample of 65 Dutch and 47 German medium-sized companies in different industries. Organisational performance was measured by achievement of goals and return on assets, a common measure of a company's economic performance, which reflects its long-term financial strength. The results of this research demonstrate that error management culture predicts profitability and firm performance (goal achievement). Common practices in error management culture, such as communicating openly about errors, helping out when errors occur and sharing error knowledge, are positively correlated with firm performance. The results show a significant positive correlation with changes in the return on assets, over and above the effects accounted for by prior firm performance.

Baer and Frese (2003) further analysed underlying processes in the sub-sample of 47 German companies. They examined the effect on organisational performance of organisational practices that support open and trustworthy interactions in the workplace. Such interactions are needed to create a climate of psychological safety. Psychological safety here refers to a sense of being able to work, act and express oneself without fear of negative consequences such as being penalised, ridiculed or censored. In a climate of psychological safety, employees feel free to speak up without fear of being penalised or rejected. Baer and Frese (2003) showed that a company's return on assets and achievement of goals was predicted by a climate of psychological safety. In other words, organisations

are more successful in generating earnings and achieving goals when they provide a non-threatening work environment.

Interestingly, when organisations are open about errors, and respond in a constructive manner, fewer errors are actually made. At first glance, this seems contradictory. Indeed, when organisations start acknowledging errors, their numbers often seem to increase at first as employees report errors that may have been covered up previously. This effect can deter organisations from starting up an error registration system or stimulating their employees to be open about what goes wrong. This is unfortunate because while a more open approach may result in an increase in reported errors at first, it has a positive effect on organisational performance over time.

Open and constructive responses to errors are positively associated with client satisfaction and their perceptions of service quality, as well as with employee satisfaction (Hofman & Mark, 2006). Common views on how to handle errors do not reflect this. Organisations and employees tend to hide errors and slip-ups from their customers. This seems to make intuitive sense: companies certainly do not want to risk reputational damage and a loss of business. However, Hofman and Mark (2006) show that hiding errors from customers actually leads to lower customer satisfaction than acknowledging them, being transparent about them and showing a willingness to learn from mistakes. The perception of service quality also increases with a constructive response to errors, and there is a good chance that not only customer perception, but also the service quality itself will benefit from the drive to learn from errors.

11.5 Improved organisational performance explained: underlying mechanisms

So what explains the positive effect of an open or constructive approach to errors on organisational performance? Part of the explanation relates to making information available on the occurrence of errors. An organisation that takes a constructive approach to errors is more transparent about the kind of errors made. This fosters an understanding of when, where and why there is a risk of errors being made. It is clear at what particular points in organisational processes things go wrong. These insights are the result of a detailed and disciplined registration of errors, which enables a structured analysis of error data. Information and insight into the specifics of errors made is a prerequisite to learning from mistakes and finding ways to prevent them in the future.

In addition to the organisational level mechanism underlying the positive effect discussed above, the positive effect of error management culture on organisational performance is also explained by the improvement in individual performance. We will now consider five mechanisms that clarify this aspect.

- When errors are approached openly and constructively, staff members feel they can speak up and that doing so will be effective (Edmondson, 2003; Morrison et al., 2011). When people communicate their ideas, complaints and suggestions, this transparency improves their collective performance. The organisation is able to improve, based on these suggestions. A culture where people feel safe to speak up is a result of social interactions about, and collective sense-making of, prior experiences with speaking up. People look for social cues about the potential consequences of their 'voice behaviour'. If the organisation responds to voice behaviour with punishment, ridicule or poor evaluations, people working for that organisation will think twice before expressing opinions or suggestions to improve performance.

This implies that an organisation can strongly influence collective beliefs about speaking up by responding to errors in an open and constructive manner.

- How organisations approach and handle errors – whether errors are hidden or communicated openly and evaluated – also influences how individual employees approach and handle errors (Cannon & Edmondson, 2001; Hofmann & Mark, 2005; Van Dyck et al., 2010; Van Dyck et al., 2005). For instance, people tend to behave more ethically sound in an organisation with a high error management culture. Research by Gronewold, Gold & Salterio (2013) focused on auditors reporting errors they discovered themselves (where they could easily choose to ignore or not report them). This research provided evidence that the presence of a high error management culture encourages a greater willingness among employees to report self-discovered errors than an error-averse climate. In addition, Gronewold et al. (2013) show that the positive effect of an error management culture on reporting undiscovered errors is greater when errors are related to competence (how good or smart you are), than when they were a result of miscalculation. This is an interesting finding for financial institutions, which have complex work processes that require employees to have well-developed competences.
- A third mechanism that explains the positive effect of error management culture on individual performance relates to people's ability to balance the tendency to correct and prevent errors with the desire to learn from them. When people make mistakes, they tend to focus on preventing errors in the future. Their first response is to hide or cover up a mistake. Their energy goes to negative emotions such as shame and guilt. People feel self-conscious. When people are able to strike a balance between correcting their mistakes and learning from them, they can focus on improving company performance instead of on

themselves. This leads to better individual performance (Homsma et al., 2007 (a); Van Dyck et al., 2010). When people take a positive approach to errors, the cognitive resources that would otherwise be wasted on self-focused attention in the case of a rigid focus on prevention (error averse), are instead used to improve performance.

- When an organisation's response to errors is more constructive, people perceive their occurrence as less negative. Making a mistake often leads to stress and negative emotions (Heimbeck et al., 2003). Stress and negative emotions as a result of a perceived failure have multiple unfortunate consequences in terms of performance, however. Over time, (chronic) stress is associated with negative health outcomes, relating to sickness and absenteeism. Stress can also be a source of new errors in itself, and it distracts people from analysing the error made, hindering a learning effect. An organisation's constructive approach to errors helps reduce the negative emotions and stress employees feel when they make a mistake or fail to accomplish something. In addition, employees are less distracted by error-related stress and are therefore better able to focus on potential learning (Hofman & Mark, 2006).
- The fifth and final mechanism underlying the positive effect of error management on performance relates to employees' beliefs or experiences regarding the common responses to errors within the organisation. These beliefs and experiences, in turn, influence their collective performance. Cannon and Edmondson (2001) argue that people hold tacit beliefs about failure and responses to errors. People in organisations talk to each other, interact and communicate about the course of events and managers' reactions to failure or mistakes. This collective sense-making is an important source of shared beliefs about failure (Morrison et al., 2011). The relationship between these shared beliefs about failure (such as "it is easy to discuss mistakes" and "problems can be addressed quickly") and performance has been empirically demonstrated (Cannon & Edmondson, 2001).

In short, a high error management culture, characterised by a constructive and open approach to errors, has a positive effect on the performance of individual employees and, as a consequence, on the organisation's performance. Within organisations characterised by an error management culture, people speak up more, report undetected errors and are less distracted by shame and guilt. This enables them to learn from their experiences. Taken together, these effects contribute to the improvement of their individual performance, and hence the collective performance of all staff. In conclusion, an error management culture improves individual performance as well as the performance of the organisation as a whole in terms of financial results, and customer and employee satisfaction. Thus, financial institutions have good reason to pursue an error management culture. The next section explores how supervisors can help financial institutions improve their error management culture.

11.6 Supervisors can ask financial institutions to improve their error management culture

All organisations benefit from improving their error management culture, but financial institutions may benefit even more from improving their approach to errors. Providing financial services is highly challenging: products and services are complex and the context is dynamic and unpredictable. Full monitoring of individual performance to prevent errors is unrealistic. Encouragingly, there is scientific evidence that the positive effect of error management culture on performance is stronger when the context is dynamic and the products are complex (Hofmann & Mark, 2006; Van Dyck et al., 2005). Hence, financial institutions stand to benefit more from improving their error management culture than companies with standardised products and predictable environments. In light of this, financial supervisors should adopt error management as a standardised supervisory topic.

To err is human, and financial institutions – like other types of organisations – differ in the ways they approach and handle errors made by their staff. This is an aspect of a financial institution's organisational culture that supervisors can analyse and actively address where necessary. Financial institutions can be asked to improve their error management culture and thereby positively influence the performance of their staff and organisation as a whole. To do this, they need to develop an explicit strategy for dealing with errors. This requires a conscious decision by management to deal with errors rationally – rather than emotionally – and thus to learn from them (Van Dyck, 2005). In guiding or directing this conscious decision on how best to deal with errors in financial institutions, supervisors can benefit from literature and research on error management culture. Understanding the psychological mechanisms invoked by different error cultures may help supervisors to improve the approach of financial institutions to errors made.

Financial institutions, supervisors, politicians and the public must undergo a mental shift in order to become open and transparent about errors made in the financial sector. Of course we want financial institutions to make no errors at all; after all, our economic wellbeing is at stake. In response to incidents in the financial sector, financial institutions, politicians, the public and supervisors have adopted a zero-tolerance stance on failures in this sector. However, the research reviewed in this chapter shows the detrimental effects of wanting to rule out any and all failures. A justified zero-tolerance policy for intentional and illegal misbehaviour should not be expanded to errors in general, nor preclude acceptance of the fact that errors are and will continue to be part of reality.

We can identify concrete strategies that financial institutions can use to develop an error management culture, and that supervisors can stimulate or enforce. In doing so, we will focus on two main principles that can be used by supervisors and financial institutions. These are: (1) errors

should be identified, analysed and evaluated at organisational level, rather than addressed as problems associated with individual workers, and (2) leadership styles throughout the organisation should stimulate open communication about errors and reflect the presence of a learning climate. We will now consider the practical implications of these two principles.

11.7 Taking an organisational level perspective

The first thing financial institutions can do to improve their error management culture is to identify, analyse and evaluate errors at organisational level, rather than opting for an individual approach in dealing with errors. This is not common practice in the financial services industry and provides a great opportunity for improving error management culture.

How can a financial institution adopt an organisational approach to errors?

The first step is to decide that it is relevant to analyse the organisational practices or characteristics that may have contributed to errors and failures. Provisions can be made to facilitate the identification and analysis of errors at organisational level, for instance, by establishing and communicating reporting procedures, and actively and regularly seeking out information from employees about errors that have been made. In order to increase the identification of errors, it is crucial to have a culture of trust where employees feel safe to communicate their errors. Earlier research suggests that an effective way of facilitating the identification and analysis of errors is to combine technical and social provisions. This can be done, for example, by building an information or registration system for errors (technical change), as well as investing in a dialogue on errors (social change) (Cannon & Edmondson, 2005). The financial services industry is a business environment with a corporate culture, dominated by rational economic decision-making. As the human factor influencing performance in a professional context is generally underestimated, e.g. the impact of

emotions on decision-making, social changes may not come naturally or easily for the financial sector. Investing in technical solutions, such as building better information systems, may seem a very feasible first step. In order for the adoption of an organisational level approach to errors to be effective, however, such technical improvements need to be accompanied by social changes. These changes should induce feelings of safety and trust among employees, allowing them to openly discuss conditions that may contribute to the occurrence of errors as an organisational problem. How can such an open dialogue on errors be stimulated? Cannon & Edmondson (2005) provide some specific suggestions. They recommend that organisations reserve space and time for relevant employees to evaluate errors as a team, and to hire or develop skilled facilitators to ensure a learning-oriented dialogue during these meetings. Another suggestion is to invite employees with diverse backgrounds to these evaluations. Involving people with different views or types of expertise increases the quality of the discussions and strengthens the learning potential of the evaluation.

In taking these steps, it is important to consider the fact that some errors are more easily discussed than others. This has to do with the severity of the consequences. Errors with severe consequences are more likely to be considered for formal evaluation, or to be discussed informally. Indeed, research has shown that people tend to learn more from errors with severe consequences than from those where the after-effect is less severe. Nevertheless, considering errors with less severe consequences can also help the organisation to learn. Openly discussing such "minor" errors may also seem less threatening and can help the organisation communicate the importance of considering all errors made. Moreover, it conveys the willingness to learn from errors instead of denying them. Thus, error evaluation should not only address the "big ones"; routinely considering the learning potential of smaller errors contributes to the development of an error management culture (Homsma et al., 2007 (b); Sitkin, 1992).

11.8 Putting leadership to work

The second thing financial institutions can do to improve their error management culture is to expand their organisation's leadership styles. Board members, directors, top management, middle management and team leaders – anyone with a managerial or leading position – should be aware of their central role in maintaining or creating an error culture through their responses and approach to errors. Their behaviour and responses to errors are a crucial factor in the development of tacit group beliefs on error handling.

How to achieve an improved error management culture through leadership?

The first thing leaders can do is to stimulate open communication about errors and to create a learning climate (Cannon & Edmondson, 2001; Rybowskiak et al., 1999). This can only be expected to occur when leaders are willing to acknowledge and consider their own role in the occurrence of errors, as a way of modelling desired behaviours. Thus, leaders should openly talk about errors in the organisation, including their own failures, and present these as a learning opportunity.

In addition to modelling desired behaviours, leaders can respond to errors consciously and consistently in a way that minimises employees' potential concerns about consequences for their status in the organisation (Edmondson, 2003). For instance, leaders can be very careful about how they discuss an error within their teams: adopting an open and unambiguous approach, emphasising the importance of learning from what happened. In addition, they can ensure that their responses do not undermine the status of the person who made the error, avoiding any negative comments to others about the person's competences. Finally, in order to create open communication on errors, leaders can create a supportive work environment by providing effective coaching and

developing their managerial coaching skills. It is important to stress here that leaders would be well-advised to actively work on stimulating open communication as people are inherently hesitant to talk about their errors. The leader can, for instance, make clear that self-reported errors are never followed by blame and punishment, while covering up errors has a direct negative impact on the performance appraisal. People subconsciously or consciously believe that talking about errors could lead to a negative evaluation of their skills, their knowledge or intelligence (Edmondson, 1999; Van Dyck et al., 2005). This is why leaders must really go out of their way to create a sense of trust, and ensure that people communicate openly about things that go wrong. A one-time evaluation is not enough; enduring efforts to stimulate a dialogue on errors are needed.

Once leadership succeeds in creating a learning climate and open communication about errors, leaders can increase employees' willingness to reveal errors by simply asking them to do so. They can also ask them to think about and diagnose the sources of errors made, and to come up with suggestions for mitigating the consequences by promoting early discovery of mishaps. Management may develop an "error management instruction" for this purpose. Such an instruction is often an explicit encouragement to make errors, emphasising the positive information feedback from errors that enhances learning. This type of explicit instruction has been shown to have positive effects on people's performance because they are more inclined to discuss and learn from their errors (Heimbeck et al., 2003; Keith & Frese, 2008).

The above suggestions concerning leadership development require a fundamental change in the typical managerial mindset (Cannon & Edmondson, 2005). For instance, leaders need to learn how to reframe errors as part of professional life and as a necessary occurrence to learn from and grow, instead of communicating that errors are not tolerated, in the hope that this will help to avoid or prevent their occurrence.

Leaders need to trust that individual and organisational performance can be improved not by avoiding errors, but by learning from errors. This mindset shift towards a learning orientation goes hand in hand with a long-term perspective on organisational performance and development.

11.9 Conclusion

In this chapter we reviewed examples of effective and less effective practices in error handling in the context of the financial services industry. The objective was to reveal how different approaches systematically have different effects. As evidenced by prior research on error management, when financial institutions understand and recognise the effects of their specific way of handling errors, they can optimise their approach to handling them. To stimulate this understanding and recognition, supervision of behaviour and culture can target error management culture as a specific supervisory topic. The psychological theory and research discussed here can thus help create a deeper understanding of the current error management culture in financial institutions we supervise, and the (unwanted) effects this culture is likely to have. Explicitly acknowledging and considering these mechanisms enables supervisors to ask financial institutions to optimise their error management culture, and thereby improve their financial and organisational performance.

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The way forward for effective external supervision is to influence internal supervision¹

12.1 Introduction

In the wake of the financial crisis, a great deal of attention in public and political debates has been paid to the role and functioning of internal and external supervision. More recently, the Libor case refuelled the debate about the need for more rules and strict supervision, from inside and outside organisations (Business Times, 2012). External supervisors were generally perceived as lacking adequate measures to effectively intervene in financial institutions when necessary, or were accused of responding too slowly. Nor were internal supervisors, such as supervisory boards, spared in the critical report of the Dutch Parliamentary Inquiry committee after the financial crisis. The report signalled a lack of prompt and adequate intervention by internal supervisors (Commissie de Wit, 2010).

Following the financial crisis, both internal and external supervisors were required to step up their game and were given more intervention options in order to increase their grip on the organisations they supervise. For instance, in the Netherlands the government gave DNB new responsibilities with the aim of making the external supervisor more forward-looking and to encourage an active focus on prevention in its supervisory approach. So since 2011, DNB has also been supervising behaviour and culture in order to prevent risky behavioural patterns that

¹ This chapter is based on research reported in DNB Working Paper no. 464 entitled "How internal and external supervisors influence employees' self-serving decisions" by Melanie de Waal, Floor Rink and Janka Stoker. The content has been adapted by the author for this specific chapter.

can negatively impact performance. And it has a shared responsibility together with the Dutch AFM, which supervises the operation and conduct of financial markets, to perform the expanded fit and proper testing of new and current management and supervisory board members (Commissie de Wit, 2010). Another example is the newly introduced intervention law, which was implemented to prevent the financial system from collapsing as a result of the next bankruptcy. This law provides DNB with more intervention tools when a financial institution is at risk, in order to safeguard the stability of the financial system. If bankruptcy is inevitable, DNB, as the new resolution authority for the Netherlands, can dissolve the institution in an orderly fashion (DNB Bulletin, 2014). On a European level, the same trend towards stronger external supervision is reflected in the implementation of a European Single Supervisory Mechanism (SSM) on 1 November 2014, which takes over external supervision of the national supervisors for all systemically relevant European banks.

The crisis has also led to more stringent requirements related to the quality and professionalism of internal supervisors, such as the supervisory board and the members of the management board, which will also be enforced by external supervisors. The expanded integrity screening tests whether supervisory and management board members have the appropriate knowledge and competences to perform their tasks. In addition, they must be capable of fulfilling these tasks effectively, based on their availability in combination with other positions they occupy, and have the right skills to meet the organisation's needs and challenges. Finally, the supervisory board is also seen as an important keeper of an organisation's sound risk management and has the task to control its risk appetite (Commissie Maas, 2009).

The most specific and far-reaching changes were made to the instruments available to external financial sector supervisors. Meanwhile, demands for internal supervision were broadened and aimed at increasing quality and professionalism. The assessment whether internal supervisors meet

these demands, for instance by means of the proper and fit test, is placed under strict external supervision. This means that supervision of the future stability and reforms needed in the financial sector has been placed almost entirely in the hands of external supervisors. This resonates with corporate governance literature, which forms the basis of the supervisory governance framework. The literature postulates that thanks to their special incentives and instruments, external supervisors are better equipped to supervise and regulate an industry like the financial sector in the best interest of the public than internal supervisors are (Barth, Caprio & Levine, 2004; Beck, Demirguc-Kunt, & Levine, 2006). However, the relevant research mainly focuses on the effect of internal and external supervision on decision-making at an organisational level, in such areas as risk-taking (Klomp & De Haan, 2012; Laeven & Levine, 2009), and as a result does not provide insight into the effects on individual and group decision-making behaviour in those organisations. This is valuable information for internal and external supervisors on how to effectively influence decision-making in the organisations that they supervise.

The relevant questions consequently are: how much influence do external and internal supervisors have on decision-making behaviour in the organisations that they supervise? And how can external supervision, with its public task of ensuring stability in the financial system, work together effectively with internal supervisors and management boards, who have a responsibility of their own with respect to safeguarding the welfare of their organisation?

To answer these questions, this chapter discusses the practical implications of social psychology research conducted by Melanie de Waal (DNB) in collaboration with prof. dr. Janka Stoker and dr. Floor Rink of the University of Groningen, which shows that internal supervisors have more influence on individuals' decision-making than external supervisors. Based on the result of our research this chapter provides concrete guidelines to help external supervisors increase their influence on decision-making in the

organisations under their supervision. This chapter aims to provide insights to external supervisors in particular on how to make more effective use of the influential position of internal supervisors.

12.2 The influence of internal and external supervision on individuals' decisions

Our research on internal and external supervision consisted of two studies, a survey and a scenario study, aimed at employees from different organisations who experience both forms of supervision in their day-to-day work. The survey included a sample of over 400 employees who have experienced both types of supervision. The resulting insights were then compared with responses from a scenario study of 62 financial managers, who were either subjected to internal supervision, external supervision or a combination of the two. In both studies, internal supervision refers to internal supervisors operating from inside organisations – such as senior management or internal audit committees – who hold employees accountable for their work ethic. External supervision refers to external supervisors who demand accountability from outside the organisation, such as DNB, the tax authorities or external audit firms.

Our research shows that both external and internal supervision have an effect on people's decision-making. However, internal supervisors always have a stronger influence than external supervisors. Our research was also set up to test whether differences in the perceived proximity of these supervisors could explain the stronger effect of internal supervision. After all, the most basic difference between internal and external supervisors is their relative closeness to the organisations that they supervise.

Consequently, it may be expected that internal supervision has a stronger effect as the supervisor is physically closer. The presence of external supervisors is less apparent as they are deliberately located outside the

organisations they supervise and consequently operate from a greater distance. Even though the current research revealed that internal supervisors are indeed perceived to be closer than external supervisors, the degree of closeness could not fully explain the stronger effect that internal supervision has.

Furthermore, our research also provided insight into the combined effect of internal and external supervision on individuals' decision-making. The results show that while the presence of both external and internal supervision does not undermine the impact of each individually, and the combination of the two does not lead to a stronger effect on individuals' decision-making. So in situations where both internal and external supervision is exercised, staff members will not necessarily make better decisions than when they are presented with internal supervision alone.

12.3 How does supervision influence people in their decision-making?

Whether supervision is performed by internal or external supervisors, it implies some form of perceived accountability as it gives those under supervision the feeling that they have to justify their actions and behaviour to an audience (Lerner & Tetlock, 1999). Moreover, this feeling will make people aware that their behaviour will be evaluated based on an established norm that is being enforced through supervision (Frink & Klimoski, 1998).

So why does accountability make people adjust their behaviour or decision-making process? Accountability fuels the basic human need for approval from others (Baumeister & Leary, 1995) and makes people want to perform well in the eyes of their supervisors (Baumeister & Hutton, 1987). Particularly in situations where people have to justify their actions, they try to communicate positively about their abilities and performance to

make a good impression on the supervisor (Frink & Ferris, 1998). After all, those who are held accountable by a supervisor expect to be evaluated and expect this evaluation to have consequences (see, for instance, Geen, 1991). As such accountability fuels self-presentational concerns (Lerner & Tetlock, 1999), it can also lead to strategic behaviour to 'please' the supervisor. Clearly, in order to avoid a negative evaluation and the associated negative consequences, people will try to act in line with the expectations of the supervisors.

Being held accountable by a supervisor, or being under supervision, consequently alerts the attention of the subjects in ways that influence behavioural outcomes, such as decision-making (Kerr, 1999; Lerner & Tetlock, 1999). Bovens (2005) suggests that this effect depends on two characteristics of accountability, i.e. the part of the decision-making process it refers to, and the audience that holds someone accountable for their actions.

Most research in the accountability domain has focused on the first aspect and has studied the effect of two dimensions of accountability concerning decision-making: outcome- and process accountability. Accountability is often studied by placing an observer in the next room to which the subjects have to either justify the outcome of their decision – for instance the amount of money invested in a business project (i.e. outcome accountability) – or the decision-making process preceding the investment decision (i.e. process accountability; Pitesa & Thau, 2013). Although several accountability researchers have proposed the relevance of the audience holding people accountable, either an internal or external audience, this aspect has not yet been studied empirically (Frink & Klimoski, 2004).

The abundant research on process- and outcome accountability has shown that process accountability in particular leads to more positive effects on individuals' decision-making than outcome accountability (Pitesa & Thau, 2013; Siegel-Jacobs & Yates, 1996). The reason for this is that outcome

accountability can have undesired side effects, such as 'short-cutting' to show the desired end result, whereas accountability on process makes people think more deliberately and consciously about their decisions and the process preceding them. Eventually, this leads to better decisions (Lerner & Tetlock, 1999). In a similar vein, extensive research is needed to study the different effects of an internal or external audience, since it remains to be investigated whether internal and external supervisors are both equally effective in reducing employees' self-serving decisions.

12.4 Why does internal supervision have such a big influence on decision-making?

The finding that internal supervision has a stronger influence than external supervision resonates with earlier social psychology work which generally shows that internal groups have a greater influence on individual behaviour than external groups (Platow & Van Knippenberg, 2001; Smith & Louis, 2001). There is only limited research available which shows that external groups also is an important stimulus for people to change their behaviour (Louis, Taylor & Douglas, 2005).

Moreover, research shows that internal groups have a large normative influence, especially when people are held accountable for their actions by such internal groups (Brass, Butterfield & Skaggs, 1998; Tetlock, Skitka, & Boettger, 1989). People care more about the opinions of these internal groups, who are closer to them and are important for their self-image, as they want to maintain a positive self-image and to perform well in the eyes of this internal group (Ellemers, Spears & Doosje, 2002; Noel, Wann & Branscombe, 1995; Sleebos, Ellemers, & De Gilder, 2006;).

Consequently, organisation members will pay more attention to the views of their fellow workers than to those of outsiders when making decisions (Gino, Ayal & Ariely, 2009), as they feel committed to their organisation

and its representatives (Ellemers, De Gilder, & Haslam, 2004). Hence, being supervised by such internal groups will make individuals pay attention to the norms of those groups and they will act accordingly.

12.5 How does the combination of internal and external supervision influence decision-making?

This is a relevant question for supervisors nowadays as organisation members are exposed to a combination of supervision forms (Green, Visser & Tetlock, 2000). Our research shows that the combined effect of internal and external supervision does not lead to an additive or counterproductive effect as is proposed by corporate governance literature as discussed below.

On the one hand, research in this area suggests that internal and external governance mechanisms even out each other's weaknesses and are more effective when combined than they are separately (Becher & Frye, 2010; Walsh & Seward, 1990). In other words, when these weaknesses are compensated for, both internal and external governance mechanisms will reach their full potential, making their combined effect stronger than their separate 'flawed' effects.

On the other hand, there is also corporate governance research that suggests that supervision by external supervisors can overrule internal supervisors' attempts to influence decision-making in their organisation despite their strong separate effect. Governance scholars argue this is because an external regulator makes people's attention shifts towards fulfilling the demands (Boo & Sharma, 2008; Li & Song, 2013; Weir, Laing & McKnight, 2002). This is also known as a crowding out effect, which means that the pressure of an external regulator is believed to be stronger and more urgent on the short term, which may draw attention away from the demands of internal supervisors (Frey & Jegen, 2001).

Our research presented in this chapter adds another perspective to the options discussed above and indicates that internal supervision is more effective in influencing individuals' decision-making than the combination of both forms of supervision. This implies that even when internal and external supervision are both present, the influence of internal supervision prevails and will remain the strongest force influencing individuals' decision-making.

12.6 Additional research into the effect of different types of internal and external supervision

Given the broad basis of the research reported in this chapter, additional research is necessary to determine the degree to which these results apply to different forms of internal and external supervision. For instance, the presence of internal supervisors was defined in rather broad terms, i.e. internal supervision can range from top management in organisations to internal audit committees. This broad definition was used to ensure that the diverse and international sample of the reported studies would completely grasp the concept of internal supervision. With this limitation in mind we can make guarded inferences about the implications of our findings for specific forms of internal supervision, such as supervisory boards, and even compliance and internal audit departments.

However, additional research is required to make functional distinctions between these different forms of internal supervision to unravel their separate effects. It would for instance be interesting to study the influence of a supervisory board, an independent board of non-executives that supervises the management board, as a specific form of internal supervision that is typically seen in Rhineland countries, including the Netherlands. By comparison, most Anglo-Saxon countries have a one-tier board system, which includes non-executive members. Supervisory boards in the Netherlands have a hierarchical relationship with their management

boards and, according to the Dutch Corporate Governance Code, control their remuneration and can also hire and fire board members (Cools & Winter, 2013).

Future research should also focus on the role of compliance and internal audit as specific forms of internal supervision, which form the second and third lines of defence. Their relationship with the management board may be somewhat different from that of the supervisory board, since there is no hierarchical relationship, but a formal relationship where the assessments of compliance or internal audit departments can have a major impact on the functioning of the management board. Too many 'red lights', i.e. negative evaluations, in these assessments are usually not helpful for management board members' careers. Given these distinct relationships, both in a formal and psychological sense, it would be interesting to study whether they also have different degrees of influence on decision-making on the board.

Furthermore, the specific research discussed is also based on a rather broad definition of external supervision, which mainly adheres to traditional forms of supervision, such as prudential supervision by DNB, and supervision by the tax authorities and external auditors. Obviously an external supervisor such as DNB may have a different impact than external auditors.

Moreover, DNB uses different approaches in its role of external supervisor. These approaches could also influence decision-making in supervised institutions differently. For instance, traditional external supervision focuses more on the outcome of decision-making (outcome accountability) when determining whether an organisation complies with a certain rule or ratio. Whereas DNB's supervision of behaviour and culture is targeted at the quality of the decision-making process (process accountability), and examines whether a board has considered all the relevant risks and interests in its decision-making process (see Chapter 4 on methodology). Hence, it would be valuable if future research focused on the interaction

between accountability type (process/outcome; Siegel-Jacobs & Yates, 1996) and the effect of external supervision on decision-making.

The research of specific forms of internal and external supervision also raises the question of what could explain their influence. Since proximity could not explain the stronger effect of internal supervision, even though internal supervisors were perceived to be closer than external supervisors, future research should look at alternative explanations for the differences in influence of internal and external supervisors. Knowledge of the underlying processes is important to understand why a certain form of supervision is effective and provides internal and external supervisors with information on which influence tactics they should use.

A possible explanatory variable may be the power and specific power bases that these supervisors have. The first results have indeed shown that the heavier influence of internal supervision, in the broadest sense of the word, can be explained by the fact that internal supervisors are perceived to have more power, specifically more power to impose sanctions or give rewards². The special position that internal supervisors have in organisations provides them with more options for punishing or rewarding employees' daily work behaviour (Brass et al., 1998; French & Raven, 2001).

Unlike internal supervisors, external supervisors are unable to monitor employee behaviour directly or on a regular basis, which limits their ability to reward or impose sanctions on employee behaviour (see Brass et al., 1998; Foucault, 1982; Haslam, 2004; Stigler & Friedland, 1962). Such power can explain the influence that internal supervisors have, as employees feel they are more dependent on internal supervisors for certain organisational resources, such as rewards (Hillman & Dalziel, 2003).

² See De Waal, Rink & Stoker (2015) for a more in-depth description of theoretical underpinnings of these findings and the first results.

Preliminary results of our follow-up research show that power is an important source of influence for supervisors to be aware of (De Waal et al, 2015). However more research is needed to determine the importance of power and specific power bases in relation to the effectiveness of specific forms of internal and external supervision. In addition to 'position power' (the power to give rewards and impose sanctions), the power literature distinguishes another type of power defined as 'personal power', which is based on the personal characteristics of the power holder (Yukl & Falbe, 1991). It can be expected that different types of internal supervisors will have access to personal and/or position power, whereas external supervisors, such as DNB, are mainly perceived to have position power in the form of imposing sanctions. Ultimately this research will inform internal and external supervisors which potential sources of influence they can access and how to put these powers to use. Therefore, future research should study the degrees of power and specific power bases in relation to the internal and external supervisory bodies discussed.

12.7 Practical implications for external supervision

Our results have significant practical implications for the focus of external supervision in general, and cooperation with internal supervision in particular. First of all, the finding that internal supervision has a stronger influence than external supervision and is also the dominant force when the two forms of supervision are combined, implies that external supervision can use its capacity more effectively by influencing internal supervision rather than by trying to independently influence organisations under supervision. This is especially true for issues that internal supervisors have a better overall view and grasp of. External supervisors should cooperate more closely with internal supervisors and make effective use of their influential position. This will enable external supervisors to have a more effective impact on the organisations that they supervise by indirectly influencing decision-making.

Even though the results reported here show that internal supervision has a stronger influence on decision-making, this does not imply that external supervision has no influence at all. In fact, external supervisors have their own task and mandate when it comes to protecting societal interests, which can sometimes conflict with the interests of the organisation being safeguarded by internal supervisors (De Ridder, 2013). In such cases, external supervisors should intervene.

Such intervention by external supervisors can certainly be effective in the short term when internal supervision fails and/or has blind spots based on its long-term affiliation with the organisation (Golden-Biddle & Rao, 1997). External supervision then acts as an outside trigger for change. Still, internal supervision is better positioned to monitor such change in the long run and will probably have a more lasting influence. Influencing and strengthening internal supervision becomes even more urgent for external supervisors given the 'Europeanisation' of supervision, with the transition of national bank supervision to the ECB and the implementation of a Single Supervisory Mechanism in Europe, which further increases the distance between external supervisors and organisations.

External supervisors have different ways of influencing and cooperating with internal supervisors. One of these is initiating more frequent contact with supervisory boards and influencing their effectiveness. Having a regular dialogue as part of the standard external supervisory programme with internal supervisors can help gain insight into important developments in the organisation as well as the particular concerns and focal points of supervisory boards. It is also an opportunity to make sure that supervisory boards are on the same wavelength as external supervisors and to ensure that internal supervisors are aware of specific focal points of the external supervisor, for instance behaviour and culture on the board, and can monitor whether regular decision-making on the board is consistent with the norms of sound decision making (as explicated in Chapter 5).

A more explicit intervention would be to openly discuss the relationship of both forms of supervision during these regular meetings between internal and external supervisors. This does not necessarily change the formal division of (accountability) roles between internal and external supervision in relation to the board (Sinclair, 1995). However, it does provide external supervisors with the opportunity to make effective use of the beneficial position that internal supervisors have and the psychological influence that accountability to such an audience has on changing employee behaviour. For example, external supervisors can communicate that they will deliberately take a step back to provide more room for internal supervisors to play their role, in order to allow internal supervision to have maximum influence.

Moreover, external supervisors can focus on assessing the quality of leadership in the organisations that they supervise. By doing this, they can influence the quality and composition of the management and supervisory board as part of their formal assessment, for instance by means of integrity screening. This is also an opportunity for external supervisors to assess whether nominees for internal supervisory positions are aware of the influence that they will have on the behaviour of employees and board members and to assess whether the nominee will use this influence to its full potential. After management and supervisory board members have been appointed, external supervisors should continue assessing the effectiveness of management and supervisory boards by means of close monitoring.

12.8 Conclusion

External supervisors can enhance their impact on the organisations that they supervise by influencing the quality and focus of internal supervision and by increasing their cooperation with internal supervisors. The research reported in this chapter shows that internal supervisors have more influence than external supervisors on individuals' decision-making, also in situations where both internal and external supervision is exercised. This requires a shift in the focus and balance of internal and external supervision, whereby external supervisors should cooperate and communicate with internal supervisors more, thus exerting their influence indirectly on employees' decision-making. By doing so, external supervision can make more effective use of its capacity than by working independently of internal supervision. External supervisors can use their formal position to facilitate, strengthen and control the governance and quality of internal supervision in supervised organisations. They can, for instance, assess the suitability of the individuals playing these important internal supervisory roles.

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The behaviour and culture supervision team

The department responsible for supervision on governance, behaviour and culture is an expert centre. It forms part of a separate DNB division comprised of expert centres. The other expert centres focus on integrity, market access, intervention and enforcement, and fit and proper testing. DNB has made the strategic choice to organise behaviour and culture supervision as a horizontal expert centre, so that it could function independently and exercise countervailing power in respect of DNB's regular supervision.

The team has a multidisciplinary composition, its members bringing expertise on organisational and social psychology, law, business administration, change management and governance. Most team members have more than 15 years' experience in supervision of behaviour and culture, with a background in consultancy, supervision and management. We believe this diversity is crucial for our supervision to be effective .

We make sure our inspections are always performed by at least two B&C supervisors, so that we adhere to the four-eyes principle in supervision and avoid bias.

On the following pages, we will introduce the team members who contributed to this handbook.



Dr Mireia Raaijmakers (1974)

Examining Officer Expert centre Governance, Behaviour and Culture at DNB (DNB, the Dutch central bank), editor of this book, author of Chapters 1, 3, 4 and co-author of chapters 2 and 10.

Mireia has been involved with supervision of behaviour and culture in the Dutch financial services industry since it was started in 2010. Prior to joining DNB, she worked as a consultant at consultancy firms and government organisations in the field of organisational development and change. Mireia studied organisational psychology and obtained her PhD on diversity management and organisational change. Her expertise includes understanding and influencing the behaviour of individuals, groups and organisations, especially during large-scale culture changes. She believes that understanding people is equally important for effective supervision of organisations as understanding figures.

Before joining DNB, Wieke worked as an organisational consultant on leadership and change. Five years ago she joined DNB to co-develop the method for supervising behaviour and culture in the financial sector. Wieke is an organisational psychologist, specialising in change management. She is currently writing her PhD thesis on culture in the banking sector, under the supervision of Professor Naomi Ellemers. Her research project links psychological studies to the banking context, with the aim of identifying levers that banks can use to improve their performance through a focus on behaviour and culture interventions.



Wieke Scholten (1979)

Examining Officer Expert centre Governance, Behaviour and Culture at DNB, author of Chapter 11 and co-author of Chapters 2, 8 and 10.

Mélanie has been involved in the development and execution of DNB's supervision of behaviour & culture since 2011. She started her career in the banking industry in the role of company lawyer and subsequently in commercial functions. After that she worked as a consultant advising financial institutions on Regulatory Compliance and People & Change Management. Mélanie studied Law and Change Management and is a certified coach (CPCC). In her work she focuses on investigation and evaluation of Board Effectiveness, Change Effectiveness and Risk Culture. Her goal is to submerge the authenticity of leaders to enable them to provide the teams they lead with an unique contribution.



Mélanie Rouppe van der Voort (1969) Examining Officer Expert centre Governance, Behaviour and Culture at DNB and author of chapter 7.



Anoushka Wajer (1971) Examining Officer Expert centre Governance, Behaviour and Culture at DNB, co-author of Chapter 8.

Anoushka joined DNB since 2014. Prior to joining DNB she was a regional managing director for the consumer market at a Dutch commercial bank, after having worked as an HR-manager. She is convinced, based on the experience she gained in various positions and her formal training as an organisational psychologist, that organisations can only survive if they foster a sound corporate culture. Anoushka aims to contribute to the health of the Dutch financial sector by conducting effective and efficient supervision.



Wijnand H.J.M. Nuijts (1967)

Head of the Expert Centre for Governance, Behaviour and Culture and author of Chapter 5.

Wijnand Nuijts has headed DNB's Expert Centre on Governance, Behaviour and Culture since 2011. His background is in international and civil law and he worked as a corporate lawyer with a Dutch law firm before joining DNB in 2003. Prior to his appointment as head of the Expert Centre, he held management positions in different DNB divisions and supervised large Dutch insurance companies. Wijnand propagates a closer focus on the interface between the structure of governance and its effectiveness. He takes great interest in analysing the processes at the root of boardroom decision-making processes.

Moritz joined the expert team for Governance, Behaviour and Culture in 2013. Most of his work involves conducting assessments of behaviour and culture in financial institutions. He also develops frameworks and instruments for such supervision. Before joining DNB, Moritz worked as a consultant on leadership and conflict management. He studied Organisational Psychology, and he is currently writing his PhD thesis about leaders as mediator in employee conflicts at KU Leuven, Belgium. Moritz' specific expertise is leadership and how it affects employees, teams, departments and an organisation's climate and performance.



Moritz Römer (1980)

Examining Officer Expert centre Governance, Behaviour and Culture at DNB and author of Chapter 6.

Jildau has been involved with the start-up of the supervision of behaviour and culture at DNB in 2010. Prior to her work at DNB, she has worked at Baker McKenzie and at the Netherlands Authority for Consumers and Markets. Jildau studied law at the Amsterdam University and attended an exchange LL.M programme at the New York University. After working more than ten years as a supervisor she is convinced that intervention in the field of behaviour and culture helps to solve the underlying problems within an organization and generates a more lasting effect. She is especially interested in stimulating (culture) change in the financial sector. In addition, she enjoys working together with supervisors of other organisations as the AFM and ECB who are implementing similar methods of supervision.



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Examining Officer Expert centre Governance, Behaviour and Culture at DNB and author of Chapter 12.

Melanie joined DNB in 2011 and has been involved in supervision of behaviour and culture in the financial services sector right from the start. She has a background in business administration and specialises in the area of change management and human resources management. She is currently writing her PhD thesis on the effect of internal and external supervision on decision-making, at the University of Groningen. Melanie is especially interested in the interaction between structural elements and behavioural processes in organisations, and aims to bring scientific insights to DNB's supervisory practice.



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Ingeborg has been involved in supervision of behaviour and culture in the Dutch financial services sector since 2013. Prior to this, she worked as an Examining Officer at DNB's Expert Centre for Pension Fund Governance and Organisation. Before joining DNB, Ingeborg worked at various financial institutions as an HR manager in the areas of management, organisational development and change. She studied law, as well as compliance and integrity management. In addition, she studied art therapy and worked with children as a therapist for five years. She specialises in understanding and influencing the behaviour of individuals and groups within organisations. She believes that the key to effective supervision of organisations is understanding what makes people behave the way they do.

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2015

2008 – The scale of the financial crisis showed us that supervision on figures and facts no longer sufficed. More than ever, we realised that our supervisory scope should be extended to include the people who pull the strings. Acting on this lesson, DNB launched a new kind of supervision in 2010; supervision of behaviour and culture.

This book addresses questions such as How should we start this type of supervision? What tools and theoretical background should we apply? What kind of expertise is needed? Its foundation lies in a systematic approach based on field experience and substantive scientific research. Plus a deep-rooted conviction that this kind of supervision is a much-needed additional tool to further strengthen supervision.

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