CHANGING THE CULTURE OF BANKING – HOW SOCIO-TECHNICAL SYSTEMS CAN CONTRIBUTE

Summary

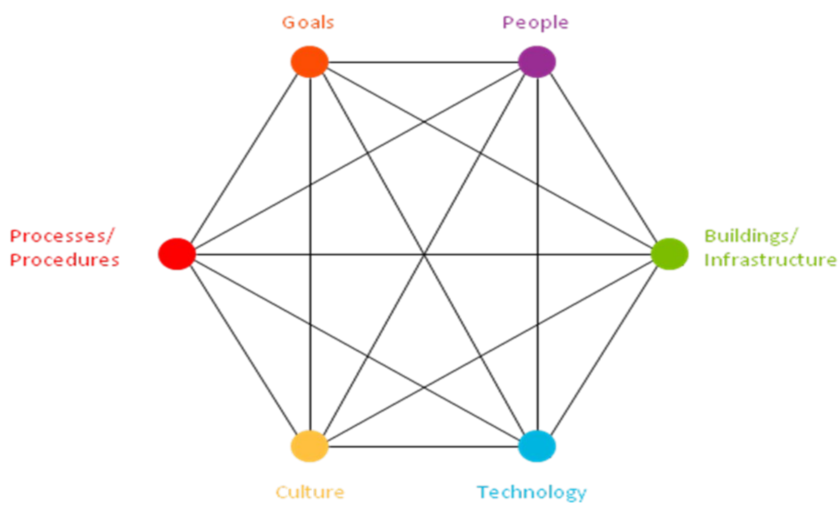
Changing the culture of banking has been referred to by, amongst others, the Chancellor of the Exchequer and the Governor of the Bank of England. However, these rather glib assertions view "culture" as something that it is not only possible to change but that this can occur quickly. In this paper we apply socio-technical systems theory to banking reform. In particular we analyse what happened in the Lehman Brothers' collapse and what needs to be done to change the banking culture.

Objectives and Introduction

The objectives of the session are to demonstrate the practical value of socio-technical systems theory to helping analyse complex problems and to show, to the wider public as well as psychologists, how psychology can make a significant impact to the very current debate on banking reform.

Socio-technical systems theory has enjoyed around 60 years of development and application internationally by both researchers and practitioners (e.g., Baxter & Sommerville, 2011; Carayon, 2006; Clegg, 2000; Mumford, 1983; Trist & Bamforth, 1951). The theory advocates when designing and operating any new system it is critical to focus on and optimise both technical and social factors (e.g. Cherns 1987). It is inevitable that changes to one part of a system will necessitate subsequent changes to other parts; so, to optimise success, the system should be considered holistically (e.g. Clegg & Shepherd, 2007). Thus, people, processes and procedures, goals, culture, technology, and buildings and infrastructure should all be viewed as interdependent and given joint consideration

Figure 1: A socio-technical systems perspective



The theory visually demonstrates the interdependent nature of organizational systems and provides a framework for analyzing the linkages and relationships between different social and technical aspects of an organization. The potential value of applying such an approach is that it provides a structured and systematic way of analyzing complex systems, problems and events.

Socio-technical thinking can be applied retrospectively to analyze problems experienced with large projects and, subsequently, to assess (and develop contingencies for) the risks that may potentially arise on similar projects in the future. By using a variety of available sources, e.g. Valukas (2010), and by taking a systems approach to the fall of Lehman Brothers we can see the reasons not only why it occurred but also the range of the solutions required to reduce the possibility of this happening again.

LEHMAN BROTHERS' COLLAPSE

Goals

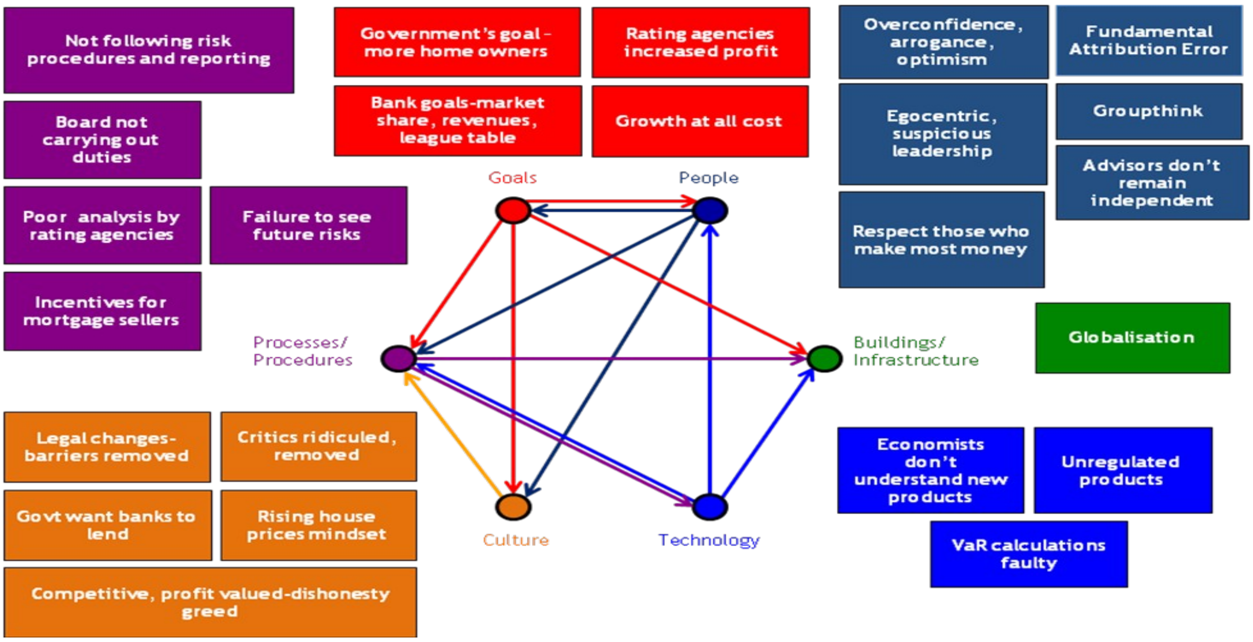
This was not just a failure of the bank itself but of a range of other organisations and agencies too, each of which had their own goals. The US Government had a stated aim of achieving greater home ownership. It believed that the banks were not lending to those from the lower socio-economic groups and those which were performing least well in this area were being penalised.

The bank in turn had its own goals which were to generate revenue, increase market share and to move up the league table of banks. Size was seen as important so growth was important, almost at any cost. In addition, the ratings agencies, which have a critical role in determining how risky any investment is, wanted to increase their profits. They gave their approval to the most toxic products.

Processes/Procedures

There were serious failures of processes. Throughout the whole system the need to generate profit was paramount. Risk and compliance procedures were not followed for the most complex and newly developed products. Not only were the rating agencies negligent in their duties but they did not evaluate the riskiest products with the thoroughness required. The bonuses paid to the bankers have received a lot of attention and this contributed to the short-term thinking that prevailed. In addition financial incentives were given to mortgage sellers to provide as many borrowers as they could. The board of non-executive directors however also contributed significantly to the bank's collapse by not carrying on their duties properly. As long as the bank made money they were prepared to believe that the key officers were doing their jobs properly. Their acquiescence lead to bank's directors withholding information from them.

Figure 2: Lehman Brothers' collapse



People

There were serious failings in the leadership of the bank, in particular the CEO Dick Fuld and the COO Richard Gregory. Their style was egocentric and suspicious; rewards and respect were paid to those making the most money. A culture of groupthink arose as the leaders surrounded themselves with like-minded people. This led to the leaders taking credit for the bank's success and blaming other factors for any difficulties i.e. fundamental attribution error.

The success of the bank led to over-confidence and a belief that it could never fail. This feeling of being special was in fact encouraged from the point of selection where candidates from the top US universities were effectively flattered into joining the bank, rather than making them go through a rigorous process. Promotions were carried out unsystematically with senior managers appointing favourites which increased the groupthink mentality.

The younger bankers in addition had never experienced a bear market and consequently had no reason to doubt that house prices would only continue to rise. This emotional reaction - based purely on their limited experience coupled with the success they were seeing, as measured by profits and bonuses – fuelled the decision-making at that time. The effect of these positive emotions – confidence, optimism, success – impacted and supposed independent advisors who did not look beyond the short-term for their analysis.

Building/Infrastructure

The relevance of this section is the way debt was shared. The products were global in nature which meant that when the collapse came its impact was felt around the world.

Technology

Value at Risk system was the way of calculating the risk of any product. The system did not flag up any special concerns about the new financial products, which indicates flaws in the programme. The most toxic products were unregulated and so it was not seen to be so important to measure the risks. They in effect slipped through under the radar. The products themselves were very complex which meant that not only did senior management but also economists did not understand them.

Culture

Legal barriers had been removed several years earlier which had been designed to keep separate retail from investment banks. In addition government regulators did little to prevent the mergers from taking place. The government, in addition, wanted the banks to lend which contributed to the frenzied activity at the time. There was a mindset - held by the banks, credit agencies and government – that house prices would not fall, which in their view mitigated any risks involved. The culture within the bank was characterised by excessive competitiveness which led to greed and dishonesty. Finally, any critics of the banking strategy were ridiculed, ignored or removed.

This analysis reveals the interdependence of several factors relating to the bank's ultimate collapse. More significantly this approach also indicated that "changing the culture" has to be a multi-dimensional approach. A lot of attention has been paid to bank leadership and bonuses, both of which are relevant. However, more attention needs to be paid to other parts of the system if we are to reduce the likelihood of another collapse occurring. In this paper we shall encourage interaction by asking the audience to work in groups to discuss the analysis and to suggest ways in which psychologists can influence and impact public policy in this highly significant debate.

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