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Banks are brought down by overblown bureaucracies

Bureaucratic management systems that enable executives to take risks without responsibility are largely to blame for the economic crisis, according to a study funded by the Advanced Institute of Management Research (AIM Research). Poor risk management was at the heart of the sub prime meltdown in 2007, it can be blamed for Lloyds TSB's problematic acquisition of HBOS and it continues to haunt the banks today.

'Imagine a plane, where the decision about whether it is safe to fly is taken not by the pilot but by the airline boss and you get an idea of how some financial institutions are managing risk,' says Julian Birkinshaw of the London Business School.

He points out that in the years leading up to the credit crisis, financial institutions focused unduly on the formalisation and externalisation of risk management. Risk was evaluated through bureaucratic procedures. Validation was handed over to a bureaucracy of outside regulators and credit-rating agencies. This, he says, allowed individuals to detach themselves – legally and morally – from the system in which they worked.

The study argues for a shift towards greater personalisation of risk management, particularly in large firms – a system where the individuals who make the decisions take personal responsibility for evaluating the risk and for the consequences of their decisions.

It is not that formal procedures and outside agencies are redundant. The best-managed firms balance formalisation and externalisation of risk management with a personalisation approach. This means that there is true ownership of the decision to underwrite a risk by the manager, who has the appropriate level of expertise and information. There are formal systems for setting the limits for exposure to the types of risks that the organisation will tolerate. And, periodically, external agencies are brought in to validate and quality assure the internal processes.

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Professor Birkinshaw cites the example of JP Morgan Chase, which is one of major players unaffected by the crisis. It has a highly cohesive top team that takes ownership of its risk-management agenda. In 2006, they saw early warning signals of the credit risk on mortgages and reduced the bank's level of exposure to mortgage backed securities.

By contrast, the large banks had hundreds of employees working in risk management, using procedures so carefully defined that they could no longer see the bigger picture. They have borne disproportionate losses.

And it is not just in the financial sector where rigid bureaucracies have undermined performance. Firms and organisations across the board could benefit from personalising risk management.

Professor Birkinshaw discusses the social services and argues that tragedies like the death of 'Baby Peter' could be avoided if the sector adopted a personalisation approach. In that case, the mother and child were visited 60 times by the social services but the formalisation of risk management through computer monitoring and targets meant that no individual had responsibility for the child.

Personalisation of risk is not straightforward – a corporate culture is required that is both conducive and supportive. In line with AIM Research's objective to impact on management practice, the research outlines several basic principles that firms can apply:

- Develop high quality information, effective analytical tools and the competence to interpret this information.
- Ensure that rewards are linked to decisions taken.
- Avoid situations where the decision maker is too far removed from the action to feel responsible.
- Build a supportive culture that includes a commitment to a set of non-financial objectives.
- Refuse to simplify the big picture.

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AIM Press Release

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Notes for Editors

1. The research was carried out by John Birkinshaw of the London Business School.

2. The research is based on the results of an 18-month research project on risk management in large organisations. The project involved: interviewing 40 executives in 30 companies from a diverse array of business sectors, including financial services, pharmaceuticals, oil & gas, mining, and telecommunications; conducting detailed analysis in one financial services organisation; carrying out interviews in public sector organisations.

3. AIM Research is a UK leader in the field of management research. It brings together academics, business, public sector and policy thinkers to develop world class research that has an immediate and significant impact on management practice. It addresses four main themes: Sustained Innovation, Promising Practices, Services and Productivity and Performance. AIM's research is designed to shed new light on challenges facing the UK and to inform practitioners and public policy debates.

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Further Notes for Editors

AIM Research is funded by the ESRC and EPSRC and was launched in November 2002. AIM's mission is to improve understanding of management's contribution to organizational performance, and thus UK well-being. AIM's more specific objectives are: (i) to conduct research that will identify actions to enhance the UK's international competitiveness; (ii) to raise the scientific quality and international standing of UK research on international competitiveness; (iii) to expand the size and capacity of the active research base for UK research on management; and (iv) to develop the engagement of that capacity with world-class research outside the UK and with practitioners as co-producers of knowledge about management and other users of research within the UK. For more information on **AIM** visit www.aimresearch.org

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