Synopsis

All company failure situations have, at least partly, a behavioral risk root cause. Looking beyond the scope of risk culture, leading organizations are now using behavioral science research and techniques to address specific patterns of human behavior that may lead to negative outcomes. In this article, the authors describe and give examples of behavioral risk and recommend behavioral risk management practices which can be adopted by organizations to strengthen their resilience.

strengthening resilience through behavioral risk management

by **Alexandra** Chesterfield & **Wieke** Scholten

introduction

On a chilly January morning, a routine Alaska Airlines flight turned into a nightmare scenario: mid-air, a door panel wrenched free, vanishing into the blue. The subsequent National Transportation Safety Board investigation[1] revealed four bolts that should have secured the door panel were unaccounted for. This wasn't merely a mechanical failure but a symptom of deeper systemic issues at Boeing.

When whistleblowers surfaced with alarming stories of compromised quality, ignored warnings, and retaliation for speaking up, it became clear that on the factory floor, production speed had overshadowed safety protocols. Success meant prioritizing speed over safety. The repercussions for Boeing's long-standing misdemeanors include the tragic deaths of 346 people from the 2018 and 2019 crashes[2], multibillion dollar fines, and nearly $100 billion in direct and indirect costs[3].

Boeing's string of crises follows in the footsteps of other high-profile failures: the collapse of Silicon Valley Bank, the fall of Credit Suisse, and the Volkswagen emissions scandal. Could these have been prevented? We argue yes, through organizations adopting Behavioral Risk Management.

Although corporate failures vary widely in nature and context, their underlying causes often trace back to similar roots: human behavior. This includes both the cause—normalized cutting corner behavior for example—and the reasons problems weren't prevented, such as silencing dissenting voices[4]. Put differently: all problems that occur have, at least partly, a behavioral root cause.

Behavioral Risk Management is about pre-empting future problems and identifying blind spots that risk organizational sustainability. It has the potential to transform risk and audit from rear-view to forward-looking functions. Behavioral risk mitigation involving improvements in work contexts and organisational culture also contributes to greater resilience, reduce uncertainty, and generate better outcomes for all stakeholders. We believe that current geopolitical developments and associated changes intensify the need for behavioral risk management as a stabilising forward-looking approach.

what is behavioral risk?

Behavioral risk refers to the risk of poor outcomes driven by behavioral patterns and their underlying factors[5]. In financial services, assessing and mitigating behavioral risk aims to prevent poor outcomes for the organization, customers, employees, shareholders, and society—including poor customer outcomes, talent loss, impaired innovation, decreased market share, and market instability.

While risk culture focuses on an institution's norms related to risk awareness and management, behavioral risk takes a more holistic view. It addresses specific patterns of human behavior that may lead to negative outcomes, encompassing decision-making errors, communication breakdowns, unethical actions, inadequate collaboration, and problematic customer behaviors.

From a risk taxonomy perspective, behavioral risk underlies all types of risk, including financial and non-financial risks, from financial crime to credit decisions.

Figure 1.

Our behavioral risk model is depicted in Figure 1.

What makes our model unique is its comprehensive approach combining both internal behaviors (employees) and external behaviors (customers).

Employee behaviors that – often unintentionally – may drive poor outcomes include patterns in:

- Decision making (insufficient challenge)
- Communication (emphasizing successes over failures)
- Collaboration (inadequate cross-functional work)
- Responding to mistakes (blame leading to cover-ups)
- Leadership behaviors (unfair treatment)

Customer behaviors that may harm customers or the organization include:

- Choosing sub-optimal services (not getting value for money or paying too much)
- Struggling to complete processes
- Ignoring critical communications
- Switching to competitors
- Negative word-of-mouth
- Withholding information
- Missing payments (incurring financial harm)

These behavioral patterns emerge wherever people work together. Groups develop behavioral patterns (or "the way we do things here") that both help and hinder their performance and goal attainment. Most people genuinely want to do good work and make the right choices. However, factors in their daily professional contexts can make this challenging.

Four categories of driving factors influence these behaviors:

1. Organizational factors, or "anything on paper that may drive behavior": internal (strategy, procedures, incentives) and external (customer communications, product design).
2. Social factors, or "anything between people that may drive behavior": for example, social norms, shared beliefs, psychological safety and moral climate.
3. Individual factors, or "anything within people that may drive behavior": for example, cognitive biases, capability, previous experiences and personality.
4. Contextual factors, or "anything outside of the organisation that can drive behavior": for example, external conditions like interest rates, market developments and regulatory agendas.

The links between these driving factors, behavioral patterns, and risks are substantiated by research from cognitive science, organizational psychology, and behavioral economics. While we present a somewhat simplified model for clarity, we acknowledge the complex, interrelated nature of these elements in reality.

behavioral risk management process – three steps

Having understood what behavioral risk is, how do we manage it? Behavioral Risk Management (BRM) follows three key steps:

1. **Identify**: Determine hotspots for behavioral risk using existing data or advanced analytics combining behavioral science and AI to predict where staff face challenges or customer vulnerabilities exist.
2. **Assess**: Conduct deep-dive reviews of specific areas using qualitative and quantitative data collection. For employee reviews, gather information through confidential conversations, focus groups, observations, document review, and surveys. For customer reviews, analyze transaction data, marketing responses, and feedback.
3. **Mitigate**: Address identified risk factors through targeted, behaviorally-informed interventions, ideally testing their effectiveness through experimental designs like randomized controlled trials.

To bring these concepts to life, let's examine two case studies that demonstrate BRM's practical application in financial institutions.

case study 1 – mitigating technology risk by changing behaviours

A first case study concerns a financial services firm with a digital focused strategy and highly technology-driven solutions and products. BRM was successfully deployed to strengthen technology resilience and mitigate the risk of technology issues. First, a behavioral risk review was conducted within the technology division, focusing on employee behavior, to identify those aspects of “the way things were done and why” (patterns and driving factors) that could lead to technology disruptions. For example, staff skipping steps in update processes that recently had been made more complex and time consuming. Meanwhile, there was a strong push for delivery from leadership without contextualisation of the process changes. The granular insights into what behavioral patterns and driving factors within the technology division were driving technology risk allowed the firm to address these aspects in a targeted manner. Behaviorally-informed interventions were designed and implemented. Effect measurement showed a significant behavioral change, mitigating technology risk.

case study 2 – COVID 19 “bounce back” loans: spotting a hidden credit risk

At the height of the pandemic the UK Government launched the Bounce Back Loan Scheme (BBLS), allowing SMEs to borrow up to £50,000 with a 100% government guarantee to the lender. Crucially, the guarantee protected the bank, not the borrower.

Given the government link, we suspected many business owners would incorrectly perceive the guarantee as meaning the loan was "free money", increasing the probability of later default. The behavioral assessment of this risk involved a "pub quiz" style survey sent to 1,000 business banking customers. Multiple choice questions tested understanding of key features of the loan, including who ultimately repays the loan and the consequences of non payment. The findings supported the hypothesis, with 51% of customers believing the Government, not the business, would repay the debt. Subsequently, the business attracted the highest severity/impact risk rating, given its priority to remediate.

Both case studies illustrate how BRM delivers insights about behavioral risk factors that, when addressed, can strengthen resilience and prevent future risk events that might harm institutions, customers, and society. It's no surprise that financial institutions are increasingly investing in these capabilities.

behavioral risk management in practice

Financial institutions globally have established behavioral risk management capability in various defense lines. Teams typically range from two to twelve people with multidisciplinary skills from behavioral sciences, audit, and risk. Examples of global institutions that have built such behavioral risk teams in the 3rd, 2nd and 1st Line are Citi (US), NatWest (UK), HSBC (APAC) and ING (Europe).

Regulators are increasingly encouraging this approach, with for example the Office of the Superintendent of Financial Institutions (Canada) expecting continuous evaluation of behavioral risks, the Monetary Authority of Singapore hiring behavioral risk experts in their supervisory teams and the European Central Bank recognizing BRM's crucial role in understanding bank risk management in their published guidance.

As the first teams were established around 2011, the financial industry now has over a decade of experience in managing behavioral risk. As the industry evolves further, new developments are expanding BRM's potential impact as alluded to next.

future developments

Two significant trends seem to be shaping the future of Behavioral Risk Management.

Digital footprints for measuring organizational culture

Traditional methods like employee surveys can mask issues due to response bias and normalization of problematic cultures. In other words: more surveys will not provide insight into "how things are done" in operational reality. Instead, researchers at the London School of Economics[6] are using natural language processing to analyze unstructured data from sources like staff feedback, customer comments, and incident reports—establishing links between cultural indicators and future outcomes. We see these methods of creating digital footprints adding great value to available behavioral data.

Ethical AI assistants

AI assistants designed with ethical frameworks could become impartial advisors enhancing transparency and fairness in decision processes. For example, an ethical AI in hiring could analyze applications based on qualifications while alerting HR managers to unconscious biases like hiring people similar to us. These ethical AI assistants could be deployed to improve decision-making behavior and mitigate behavioral risk.

recommended actions for risk managers

In financial services, behavioral risk management has delivered positive impact and contributed to forward-looking risk management. Next to financial services, industries such as mining and pharmaceuticals are managing behavioral risk explicitly. If your organization hasn't yet added this perspective to your risk management and resilience enhancing approach, now may be the time.

To start, you may have to overcome the following implicit beliefs preventing senior leadership from initiating BRM:

- The first concerns a degree of overconfidence that operational reality is well understood and that, for example, conducting an employee engagement survey is sufficient to substantiate that understanding.
- The second concerns a certain wilful blindness about behavioral risk factors. We shape work environments with the best intentions. It can therefore be tempting to rely on these intentions and challenging to take an honest look at daily practices.
- The third is a belief that behaviors are too difficult to change; that it will take heaps of time to shift “how things are done” and organizational culture.

Learning from experience in BRM in financial services, we can offer the following strategies to overcome these barriers.

1. Adopt curiosity: Acknowledge that despite good intentions, operational realities drive outcomes. How decisions are made, customer journeys are shaped and how shortcomings are responded to: these aspects drive good and poor outcomes. The most effective BRM approaches start with a curiosity to know that operational reality.
2. Build in-house capability: Develop expertise to provide insights into daily contexts and behavioral risk factors. Behavioral science backgrounds help to adopt evidence-based review and behavioral change methodologies.
3. Start small and measure effectiveness: Demonstrate that BRM works by showcasing interventions that successfully shifted behavior at work, and shaped work contexts that encourage aspired employee and customer behaviors.

Behavioral risk management helps organizations become more resilient, more forward-looking and less reactive. As Einstein said, "Intellectuals solve problems, geniuses prevent them."

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3. https://en.wikipedia.org/wiki/Financial_impact_of_the_Boeing_737_MAX_groundings
4. See Hald, Reader & Gillespie (2023) in recommended reading
5. See full references to Scholten (2022); Eccles (2022); Raaijmakers et al. (2021) in recommended readings
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Alexandra Chesterfield has over 15 years' experience establishing and leading Behavioral Science teams to drive better outcomes in both regulatory and commercial contexts. Most recently, she led the Behavioral Risk team at NatWest Group, the UK's largest business and commercial bank, where her team's innovative work was featured in Forbes (Eccles, 2022). Previously she was the principal psychologist at the UK financial regulator (the FCA). Alex holds an MSc in Cognitive and Decision Science from University College London (UCL) and is the best-selling co-author of Poles Apart (Penguin Random House, 2021), which she also teaches as part of a course at The Intellectual Forum, Jesus College, Cambridge University. Now based in the U.S., Alex consults globally while pursuing a PhD at the London School of Economics (LSE), in their Corporate Culture and Risk Unit, where her research integrates psychological science with advances in AI and digital data to understand and assess institutional failure.

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Wieke Scholten is a social and organisational psychologist with over 22 years of experience in behavioral analysis and change in organisations, including 14 years in financial services. As a former Head of Behavioral Risk at NatWest Group Internal Audit, (Co-)Lead Partner of Behavioral Risk at &samhoud consultancy and Senior Supervisor of Behavior & Culture at the Dutch Central Bank (DNB), she pioneered strategies for identifying and managing behavioral risk. Wieke obtained her PhD in social psychology on preventing conduct issues in trading and sales businesses in banking organisations. She lectures at the Institute of Banking and Institute of Directors in Ireland and has published papers in leading journals, including the Journal of Financial Regulation and Compliance and the Harvard Business Review, on how organisations deploy behavioral science to obtain better outcomes. Wieke is founder of BR Insights, a globally operating behavioral risk management practice based in the Netherlands and the UK.

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