

## Amin Rajan: Opening Comments at *Comply & Prosper Seminar on 15<sup>th</sup> March*

I, too, would like to add my thanks to many of you in the audience, some of you have participated in the research, some of you funded and participated in the research, some of you just funded it. To all of you, I would really like to express very sincere thanks from the research team at CREATE as well as the London Human Resource Group.

(Slide 1) Geoff has mentioned that regulation emerged as the number one item on people's radar screen when we canvassed their views on our research topic. What we heard from them richly resonated with what Donald Brydon and other prominent business leaders were saying publically back in 2002-3: namely that the sheer volume of new regulation in the pipeline has the potential to convert many institutions into utilities. It was clearly time to take stock. That's what our study has sought to do.

In the limited time that I have, I would like to draw out what I believe are the three core themes from the study, which will serve to set the scene for the rest of today.

*The first of these is that regulation in their totality has proved a mixed blessing (slide 2).*

On the upside, it is believed to have delivered three very real benefits, which together have overtly kick-started ethical business cultures in the large majority of the institutions in the City (Slide 3).

First, the *Self Regulated Organisations* created by the 1986 Financial Services Act were found to be wanting in a period of ultra high growth, fuelled by the longest bull market in living memory. The flood of new money was widely mistaken as a vote of confidence, until various scandals hit the headlines. *Regulation has helped to restore trust.*

Second, there has been an explosive proliferation of new instruments - e.g. derivatives, hedge funds – that not only carry systemic risks but they also trade across national frontiers. *Regulation has promoted orderly markets.*

Finally, rapid growth in the 1980s and the 1990s had focused senior management time on front office activities to the detriment of sound governance and HR practices. Quite simply, senior managers were more interested in managing money than people. They often confused the buzz of markets with leadership.

The power of the old school tie often undermined enlightened attempts to have rational people practices that were fair, meritocratic and progressive. In a small number of prominent houses, HR was just another Cinderella function. Thus, regulation has not only provided a framework for identifying inadvertent lapses; but has also *served to draw a clear line between acceptable and unacceptable practices.*

In the process, the City has gone from a gentlemanly capitalism to regulated capitalism.

Yet, for the UK, progress towards the best-regulated economy in the world remains gradual.

On the downside, however, its not all been plain sailing, due to the unintended consequences of regulation (slide 4). These, in turn, have arisen because of challenges experienced in striking the right balance in three areas:

- *Creativity and bureaucracy:* the sheer volume of legislation since 1997 has made undue demands on senior management time to the detriment of business development. Its bureaucracy has stifled creativity and enterprise in businesses where personal insights, gut instincts and sound intuition hitherto differentiated winners from losers.
- *Enterprise and risk aversion:* the processes associated with the FSA codes, the Sarbanes Oxley Act 2002 and the employment laws are perceived as overly rigid, making inputs more important than outputs. Managers have reportedly become more risk averse than their well tuned gut instincts justify. Talented staff have left for pastures new, especially in accountancy, investment banking and fund management.
- *Customer protection and international competitiveness:* there are examples of regulatory arbitrage driving innovative products in fund management to more liberal regimes offshore. In

particular, all EU legislation is perceived as creating a level playing field only in intent, not outcomes. Most Continental countries do not, as yet, have the UK's widely acknowledged exemplary record of compliance.

Thus, we encountered two schools of thought. The first one holds a benign view that regulation is meant to kick start ethical business cultures which, over time, will ensure that regulation is no more than a safety net. The second holds a pessimistic view that too many laws are institutionalising rules to the extent that human relations, sound judgement and personal accountability are being weakened just when global competition is intensifying.

Overall, the majority of them have welcomed various bits of regulation. Some see clear benefits. Others have grit their teeth and got on with them because that's the British way of doing things. That does not detract from the fact that there have been unintended consequences, as well as costs (slide 5). A recent report from the British Chamber of Commerce put the cost of all new regulation since 1997 when the present government came to power, at £50 billion. This is an under-estimate since it focuses on the compliance cost and doesn't quantify the missed opportunities associated with the unintended consequences.

In the UK, Government departments are required to do cost benefit assessments of all impending legislation before it is passed. For some reason, the results are not publicized. Nor is there any hint of what methods are used in assessing the costs and benefits. When it comes to the EU regulation, the problem is even worse. This much is evident from the new MiFID rules that will hit the City next year. The aspirational rhetoric from the EU internal market commissioner is at variance with what Sir Callum McCarthy has said publicly (slide 6).

Be that as it may, as long as there are Parliaments, there will always be new regulation. The question is how do we minimize the unintended consequences at the point of their impact – namely the workplace? (Slide 7)

This leads to my second theme: *minimizing these unintended consequences means adopting a risk-based approach*. As we shall see later on, this is one of two key requirements, if regulation

is to promote vibrant businesses. I shall return to the second requirement later on.

Institutions are doing four sets of things in order to create a culture of compliance that aims to strike a balance between bureaucracy and creativity, blind adherence and intelligent application. (Slide 8)

The first set involves putting in place systems and controls as required by new laws, especially FSA codes, so as to be compliant. The second set involves implementing various suitability tests to ensure that people in designated jobs satisfy the 'fit and proper' criteria, as required by the law. The third set involves relying on business principles and culture – '*the way we do things around here*' - backed by individual judgement, to ensure that the spirit as well as the letter of the laws are observed, with minimum bureaucracy and hassle. The fourth set relies on overtly nurturing personal behaviours that are consistent with the espoused culture in line with the principles-based approach.

The first two sets involve high compliance and low risks in the sense that they rigidly follow the laws. The last two sets, in contrast, involve low compliance and high risk; in the sense that they rely more on culture to deliver what laws require. Currently the balance is tilted towards the first two sets because institutions do not want to be seen to be non-compliant in any way. Also, the FSA requirements involve unavoidable bureaucracy, notwithstanding their well publicised principles-based orientation. This prevailing gap between rhetoric and reality may well diminish over time, as the culture of ethics that the FSA is promoting develops stronger roots.

The first two sets, relying on overt compliance, mitigate any risk associated with non compliance. The smaller the reliance on them, the greater the '*residual risk*' arising from relying only on the last two sets. Intelligent application of regulation clearly requires a greater balance between overt controls and business principles.

The quickest actions they could take have centred on the physical and tangible aspects of their operations, which are more visible during inspection visits from the FSA and other public agencies.

In contrast, cultural and behavioural aspects are far more perceptual and intangible. Reportedly, inspectors are neither

trained to do culture audits nor do the institutions do their own. Such audits require trained intuition that understands the subtle nuances and finer meanings of day-to-day business conduct.

In any event, institutions have yet to evolve risk management tools on the governance and employment side on the scale and quality that they have on the prudential side.

On the upside, therefore, institutions have been able to satisfy the regulatory requirements. On the downside, far less attention has been paid to the spirit of the law or a risk-based approach that relies more on values and behaviours and less on systems and controls.

The challenge for the City is to accelerate the progress towards a risk -based approach. How can we do this?

The question leads me to my third theme: *it requires new skills and alliances* (slide 9).

Currently, only one in three institutions enjoins their HR professionals to assess and manage the risks associated with regulation. In seven out of ten, these professionals have not been involved even in implementing the FSA codes relating to people management. These are worrying statistics, I am sure you will agree. In part, this is because of the sheer volume and speed of the laws that have been passed lately.

To move towards a principles-based approach, HR professionals need to use the conventional tools of risk management within a holistic approach, as used in best practice firms. It starts with business strategy and identifies all enterprise-wide risks, including those arising from regulation (slide 10).

In this context, the nature of the people risks from governance and employment legislation is clearly identified, including their likelihood and potential consequences. The process involves making a considered *judgement* on two points:

- ◆ what new actions are needed to mitigate the risks, and
- ◆ how much to rely on the existing culture and people practices to prevent it.

Thus culture and practices determine the amount of *residual risk*: the more positive they are, the less the need to take mitigating actions and the stronger the residual risk. To use the driving metaphor, the more sensible the drivers, the less need for excessive traffic lights.

To cope with residual risk, it is essential to have an early warning system via various indicators, giving advance warning of impending problems. In the HR context, they include short-term staff turnover rates, absenteeism rates, grievance and disciplinary cases, staff surveys, customer perception studies, to cite a few. At micro level, they also include subtle nuances of isolated incidences and individual behaviours.

In sum, such an approach amounts to identifying the risks, assessing their likelihood and potential consequences; mitigating them through overt actions where absolutely necessary; and relying on culture and practices to cope with the residual risk. In all, it's about '*making the call*' and taking responsibility for it.

In turn, making the call means implementing what are referred to as the Ten Commandments of risk management. Together, they offer four pieces of generic advice:

- ◆ ***understand the big picture***
- ◆ ***know your business culture***
- ◆ ***know the 'engine room'***
- ◆ ***develop personal credibility.***

However, it is one thing to have advice; quite another implementing it. There's a major issue here about skills (slide 11).

Assessment and management of risks require different skill sets amongst the three distinct sets of HR professionals. HR-business partners who are close to line managers in different business units need to be far more business and people savvy than those who are subject matter experts, far removed from line managers.

In identifying, mitigating and managing residual risks they play a central role because they have a far better understanding of the cultural and behavioural realities on the ground. To be able to do it, they need to enjoy the trust of their business colleagues: that means having a credible track record, detailed understanding of

the business and sound independent judgement. Invariably, this means having a hybrid set of skills cultivated through breadth of work experiences in non HR areas.

This is in marked contrast to current reality where the vast majority of HR-business partners have majored in HR functions and little else. They also need to work closely with central HR in identifying and mitigating risks. The skill sets of central HR professionals also need to be broader based because they have to design risk management strategies in the first instance. Consequently, the career paths of many HR professionals need to be reconfigured to take in business experience.

Furthermore, most of them also need to master the risk management techniques identified earlier, duly recognising that blind adherence to regulation means higher costs and missed opportunities.

But that's not all. HR professionals need to work closely with their risk and compliance colleagues in order to ensure that:

- ◆ ***blind compliance is avoided:***
- ◆ ***managers have high quality advice***
- ◆ ***change management agenda is jointly driven***
- ◆ ***the necessary skills are there***

However, and most important, HR professionals alone cannot deliver a risk based approach. The unintended consequences identified earlier require concerted actions by three sets of entities (slide 12).

For *regulators*, the challenges are two-fold: how to minimise the unintended consequences and how to avoid a culture of box ticking. The answers are:

- ◆ having more frequent and open consultations at the formative stage
- ◆ training their inspectors to do culture audits that go well beyond systems and processes and include values and behaviours.

For *business leaders*, the challenges are three-fold: how to ensure that old and new regulation have relevance in a fast changing market environment; how its implementation should enhance rather than stifle enterprise; and how to develop a risk based

approach that honours the spirit and the letter of the laws. The answers are:

- ◆ having more intensive and frequent engagement with regulators and legislators because intelligent application requires intelligent design
- ◆ adopting a strategic approach to all risks, creating mechanisms for regular risk assessments that clearly focus on managing residual risks and allocating accountabilities
- ◆ doing regular audits to ensure that corporate culture is aligned to a principles-based approach

The challenges for *HR professionals* are three-fold: how to incorporate their strategic approaches to include all risks in general, and regulatory ones in particular, how to develop cultures and behaviours that ensure managers are entrepreneurial on the one hand and self regulatory on the other, and how to manage the residual risk. The answers are:

- ◆ re-orienting strategic HR and its skill sets
- ◆ learning the art of risk management
- ◆ promoting organisational development that runs with the grain of regulation, while minimising bureaucracy
- ◆ securing internships with regulatory bodies as part of professional development.

Ladies and gentlemen, that brings me to the end of my presentation. By presenting those three themes – on regulation being a mixed blessing, on unintended consequences, and on a risk-based approach – I hope that I have managed to convey the flavour of the report and set the scene for the rest of this event.

Before I sit down, I would like to leave you with my thought for the day. It is this:

For reasons that I mentioned earlier, the City has gone from a gentlemanly capitalism to a regulation capitalism (slide 13). If it is to retain its status as Europe's premier financial centre, one thing that will have to change is the way people risks are identified and managed. We need a step improvement.

Thank you