Why cultures fail: The power and risk of Groupthink

Received (in revised form): 14th August, 2018

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Abstract Why do terrible things happen under the watch of good leaders? Why do very smart, dedicated, well-meaning leaders make horrific mistakes? Can these problems be foreseen? How and why do these problems happen? How is it that a robust system of checks and balances designed to prevent these situations fails? Are these problems likely to happen again? In this paper, the power and risk of Groupthink is explored by examining two cases (London Whale and Sales Practices) at JPMorgan Chase and Wells Fargo. Through specific examples, the paper demonstrates that what happened at these organisations can happen in any company.

Keywords: *conduct risk, Groupthink, London Whale, Sales Practices, culture failure, cognitive biases*

INTRODUCTION

Going through the financial crisis was a horrifying experience for me. It truly felt like an out-of-body experience. Seeing financial institutions of all sizes teeter on the edge of failure and needing government bailouts was unreal. For me personally, in risk management lingo, it was a 'tail' or a 'low probability/high severity' event. My career with my beloved Wachovia was over.

Ever since the financial crisis, I have become preoccupied with understanding why terribly bad things happen under the watch of good people. Why do very smart, dedicated, well-meaning people make horrific mistakes? Specifically, I became obsessed with answering a long list of questions, such as:

- Can these problems be foreseen?
- How and why do these problems happen?
- How is it that a robust system of checks and balances designed to prevent these situations fails?
- How do we collectively as bankers, economists, regulators and politicians get things so wrong?
- How could models be so flawed and yet everyone blindly follows them?
- Are these problems likely to happen again?

And then, two other events happened that led me to the conclusion that bad things can happen at any company, no matter how good they think their culture is. Those two events were London Whale at JP Morgan Chase (JPMC) and Sales Practices at Wells Fargo.

In two previous *Risk Management Association Journal* papers,[1] Robert Prentice[2] and I collaborated on explaining some of the causes of these sorts of colossal failures. Both papers explored how, to various degrees, we are all victims of cognitive biases and thinking errors that lead to poor decision-making and gave our suggestions for avoiding these thinking and decision-making failures.

In this paper, I want to explore the power of Groupthink and specifically how, in my judgment, it relates to cultural issues at JPMC and Wells Fargo that caused London Whale and Sale Practices. My intent is not to make any of my colleagues at JPMC or Wells Fargo feel bad. To the contrary, my point is that what happened at these institutions can happen in our companies. None of us should be arrogant enough to think that we and our cultures are immune to these sorts of failures. If you think that such failures will never happen in your company, I suggest that you may want to study 'over confidence' or 'optimism bias'.

WHAT IS GROUPTHINK AND HOW DOES IT RELATE TO THESE TWO SITUATIONS AND OTHERS LIKE IT?

Irving Janis, a social psychologist, coined the term 'Groupthink' in 1972.[3] It occurs when a group makes faulty decisions because group pressures lead to a deterioration of 'mental efficiency, reality testing, and moral judgment'. Groups affected by Groupthink ignore alternatives and tend to take irrational actions that dehumanise other groups. A group is especially vulnerable to Groupthink when its members are similar in background, when the group is insulated from outside opinions and when there are no clear rules for decision making. Janis concluded that *when certain conditions exist* in a group, then *there is a reasonable chance* that Groupthink will happen. These conditions/symptoms are:

(1) *An illusion of invulnerability*: Members ignore danger, take extreme risk and are overly optimistic.
(2) *Collective rationalisation*: Members discredit and explain away warnings contrary to group thinking.
(3) *Belief in inherent morality*: Members believe in the rightness of their cause and therefore ignore the ethical or moral consequences of their decisions.
(4) *Stereotyped views of out-groups*: The group constructs negative stereotypes of rivals outside the group.
(5) *Direct pressure on dissenters*: Members pressure any in the group who express arguments against the group's stereotypes, illusions or commitments, viewing such opposition as disloyalty.
(6) *Self-censorship*: Members withhold their dissenting views and counter-arguments.
(7) *Illusion of unanimity*: Members perceive falsely that everyone agrees with the group's decision; silence is seen as consent.
(8) *'Mind guards' are appointed*: Some members appoint themselves to the role of protecting the group from adverse information that might threaten group complacency.

I found it very interesting that one of the root causes of Groupthink is cultural cohesiveness. In a cohesive group, members avoid speaking out against decisions, avoid arguing with others and work towards maintaining friendly relationships in the group. If cohesiveness gets to such a high level that there are no longer disagreements between members, then the group is ripe for Groupthink. The conclusion is that dissent or challenge is a good thing, but difficult to achieve in cohesive cultures, and those who try to practice it may be rejected the way the body rejects a foreign object.

In studying London Whale and Sales Practices, one can see various symptoms of Groupthink. These two cases are not the only examples for Groupthink. The Vietnam War, Bay of Pigs invasion, the Space Shuttle disaster, and, some argue, the Iraq invasion are other instances.

BACKGROUND ON LONDON WHALE

JPMC is considered one of the best run banks in the world. If anybody understands risks and how to manage them it is Jamie Dimon and his management team. Yet JPMC lost US$6.5bn and suffered a great deal of embarrassment. In April and May 2012, large trading losses occurred at JPMorgan's Chief Investment Office, based on transactions booked through its London branch. A series of derivative transactions involving credit default swaps (CDS) were entered, reportedly as part of the bank's 'hedging' strategy. Trader Bruno Iksil, nicknamed

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the *London Whale*, accumulated outsized CDS positions in the market. These events gave rise to a number of investigations to examine the firm's risk management systems and internal controls.[4]

BACKGROUND ON WELLS FARGO AND SALES PRACTICES

Wells Fargo's CEO and executive management prided themselves in exceptional results and a culture that believed in risk management at every level. At Wells, the power belonged to the lines of business and they believed that their operating model was superior to others. Wells Fargo resisted centralising support functions (risk, compliance, finance, HR, technology, etc.) because they believed in their decentralised line of business structure. The company had been wildly successful, so why mess with a good thing? This all changed subsequent to the sales practices scandal.

The colossal sales practices failure has been a huge embarrassment for the company and brought unnecessary pain and scrutiny by regulators to other financial institutions. The scope of Wells Fargo's fake accounts scandal covered 3.5m accounts that were potentially opened without customers' permission between 2009 and 2016.

In Table 1, various symptoms of Groupthink identified by Janis are cross-referenced to conduct by leadership in each institution.

Table 1: Groupthink symptoms and behaviours at JPMC and Wells Fargo cross-referenced

Groupthink	JPMorgan Whale case example[5,6]	Wells Fargo case example[7]
Collective rationalisation/Symptom 2: Members discredit and explain away warnings contrary to group thinking.	'CIO, particularly the Synthetic Credit Portfolio (SCP), should have received more scrutiny from both senior management, and I include myself in that, and the firm-wide Risk control function. . . . Make sure that people on risk committees are always asking questions, sharing information, and that you have very, very granular limits when you're taking risk . . . In the rest of the company we have those disciplines in place. We didn't have it here.' 'In contrast to JPMorgan Chase's reputation for best-in-class risk management, the whale trades exposed a bank culture in which risk limit breaches were routinely disregarded, risk metrics were frequently criticized or downplayed, and risk evaluation models were targeted by bank personnel seeking to produce artificially lower capital requirements.'	'Even when challenged by their regional leaders, the senior leadership of the Community Bank failed to appreciate or accept that their sales goals were too high and becoming increasingly untenable.' 'Trends in the data show, perhaps not surprisingly, that as sales goals became harder to achieve, the number of allegations and terminations increased and the quality of accounts declined.'
Groupthink	**JPMorgan Whale case example[8,9]**	**Wells Fargo case example[10]**
	In February 2012, a key risk metric known as the Comprehensive Risk Measure (CRM) warned that the SCP risked incurring a yearly loss of US$6.3bn, but that projection was dismissed at the time by CIO personnel as 'garbage.'	

(*Continued*)

Table 1: (Continued)

Groupthink	JPMorgan Whale case example[8,9]	Wells Fargo case example[10]
	'More than a Tempest in a Teapot. In the April 13 earnings call, in response to a question, Mr. Dimon dismissed media reports about the SCP as a 'complete tempest in a teapot.' While he later apologized for that comment, his judgment likely was of importance to investors in the immediate aftermath of those media reports. The evidence also indicates that, when he made that statement, Mr. Dimon was already in possession of information about the SCP's complex and sizeable portfolio, its sustained losses for three straight months, the exponential increase in those losses during March, and the difficulty of exiting the SCP's positions.'	
Groupthink	**JPMorgan Whale case example[11,12]**	**Wells Fargo case example[13]**
Belief in inherent morality/Symptom 3: Members believe in the rightness of their cause and therefore ignore the ethical or moral consequences of their decisions.	'Asserting SCP Trades Were Consistent with the Volcker Rule. The final point made in the April 13 earnings call by Mr. Braunstein was: '[W]e believe all of this is consistent with what we believe the ultimate outcome will be related to Volcker.' The Volcker Rule is intended to reduce bank risk by prohibiting high risk proprietary trading activities by federally insured banks, their affiliates, and subsidiaries. However, the Volcker Rule also allows certain trading activities to continue, including 'risk-mitigating hedging activities.' Mr. Braunstein's statement gave the misimpression that the SCP was 'hedging' risk. When the Subcommittee asked the bank for any legal analyses regarding the Volcker Rule and the SCP, the bank responded that none existed.'	'There was a disinclination among the Community Bank's senior leadership, regardless of the scope of improper behavior or the number of terminated employees, to see the problem as systemic. It was common to blame employees who violated Wells Fargo's rules without analyzing what caused or motivated them to do so.' 'Finally, until as late as 2015, even as sales practices were labeled a 'high risk' in materials provided to the Risk Committee of the Board, there was a general perception within Wells Fargo's control functions that sales practice abuses were a problem of relatively modest significance, the equivalent of a tolerable number of minor infractions or victimless crimes.'
Stereotyped views of out-groups/ Symptom 4: The group constructs negative stereotypes of rivals outside the group.	'Dodging OCC oversight went to the head of the CIO, Ina Drew, a member of the bank's Operating Committee, who criticized the OCC for being overly intrusive.' 'In the case of the bank's CRM risk metric and model, CIO quantitative analysts, traders, and risk managers attacked it for overstating risk compared to their own far more optimistic analyses.'	'Tolstedt and certain of her inner circle were insular and defensive and did not like to be challenged or hear negative information.' 'Sections of the Report below describe how Wells Fargo control functions, specifically Corporate Risk, the Law Department, Human Resources, Internal Investigations and Audit,

Table 1: (Continued)

Groupthink	JPMorgan Whale case example[14,15]	Wells Fargo case example[16]
		dealt with sales practice issues in the Community Bank. Several common themes — again, substantially related to Wells Fargo's culture and structure — hampered the ability of these organisations to effectively analyse, size and escalate sales practice issues.
Direct pressure on dissenters/ Symptom 5: Members pressure any in the group who express arguments against the group's stereotypes, illusions, or commitments, viewing such opposition as disloyalty.	'Furthermore, at least some CIO risk managers did not consider themselves sufficiently independent from CIO's business operations and did not feel empowered to ask hard questions, criticize trading strategies or escalate their concerns in an effective manner to firm-wide Risk Management.'	
Self-censorship/Symptom 6: Members withhold their dissenting views and counter-arguments.	'CIO Risk Management made a number of key missteps, including failures to (1) review the appropriateness of the CIO risk limits used from 2009 to 2012; (2) ensure that the change to the CIO Value-at-Risk ('VaR') model for the Synthetic Credit Portfolio in January 2012 was appropriate and being properly implemented; and (3) appreciate the significance of the changes in the Synthetic Credit Portfolio during early 2012.'	'Because it was the responsibility of Community Bank leadership to run the business 'like they owned it', Stumpf did not engage in investigation and critical analysis to fully understand the problem.' 'Stumpf's long-standing working relationship with Tolstedt influenced his judgment as well.' 'Third, in light of the Board's substantial doubts about and dissatisfaction with Tolstedt's leadership by the time of the October 2015 Board meeting, the Board should have been more forceful in pushing Stumpf to change leadership so that the Community Bank could move forward more quickly.'
Groupthink	**JPMorgan Whale case example[17,18]**	**Wells Fargo case example[19]**
Illusion of unanimity/Symptom 7: Members perceive falsely that everyone agrees with the group's decision; silence is seen as consent.		'Even when senior executives came to recognize that sales practice issues within the Community Bank were a serious problem or were not being addressed timely and sufficiently, they relied on Tolstedt and her senior managers to carry out corrective actions. This culture of deference was particularly powerful in this instance since Tolstedt was respected for her historical success at the Community Bank, was perceived to have strong support from the CEO and was notoriously resistant to outside intervention and oversight.'

WHAT TO DO?

As you can see, Groupthink was alive and well at these two terrific companies. So we now complete the circle and ask again, 'how can we prevent this from happening to our companies?' Avoiding Groupthink and other cognitive biases is hard to do. Daniel Kahneman (the only psychologist to ever win the Nobel Prize in economics) has devoted his entire professional life to explaining why our decisions are not always rational. If you have not read the book, *Thinking, Fast and Slow*,[20] I urge you to read it. You will develop an appreciation of how hard it is for us as human beings to overcome our thinking biases. Hence, my earlier comment that none of us should be arrogant enough to think that these kinds of failures cannot happen in our company. Wells Fargo and JPMC are good companies with terrific, smart, dedicated and ethical people. These events happened there because they can happen anywhere.

Before I share my suggestions about what can be done from a cultural perspective, let me share my thoughts about one of the most important responsibilities that we all have as risk management professionals. By virtue of our jobs, we have a fiduciary responsibility to avoid becoming a victim of Symptom Number 6 (Self-censorship: Members withhold their dissenting views and counter-arguments).

We get paid to apply our critical thinking and deductive reasoning skills to analysing a situation and then are expected to ask enough questions to satisfy ourselves that it is the right thing to do. Cultures have a way of turning us into conformists and we must recognise and avoid that. In business there is a fine line between being a constructive challenger and being an 'obstructionist'. I believe that in most institutions, risk management professionals are expected and have a cultural mandate to be effective and constructive challengers. Let me acknowledge that this is very hard to do. I remember a very smart and ethical chief risk officer who retired at 46 because he could not understand how a bunch of sub-prime loans all of sudden, through the miracle of mathematics, can turn into a AAA securitisation. Sometimes it is awfully hard to swim against the tsunami, but that is what we get paid to do.

There are a few things that you can do to help minimise the probability of occurrence in your organisation. They are as follows:

(1) Engage your CEO and head of human resources to understand and appreciate the power of human biases and thinking errors.
(2) Design an approach for making respectful challenge and dissent a cultural value.
(3) Get the executive management team to model the desired behaviour (demonstrate respectful credible challenge).
(4) Work with your human resources department to build a process for evaluating the top leaders in the company on demonstrating the desired behaviour. Hold your leadership accountable when the behaviour is not demonstrated.
(5) Recognise the symptoms of Groupthink and other cognitive biases.
(6) When appropriate, encourage debate, not conformity.
(7) When warranted, assign someone to be the challenger.
(8) Ask 'what is wrong with our idea?' or 'how can we fail?'
(9) Be fact-based and limit confirmation bias (looking for data to confirm your existing thinking).
(10) Do not treat this effort as a project, but rather as a foundational part of your culture. Institutionalise credible and respectful challenge as a cultural value.

Getting the culture right is one of the most challenging aspects of leadership. Sometime ago, someone told me 'culture eats strategy for breakfast every day.' I have found that to be a very true statement. As risk management professionals, we spend a great deal of time on processes, data, portfolio analysis, business strategies, compliance and many other important aspects of our job. But I suggest to you that we need to dial up the amount of time we spend on getting critical thinking, deductive reasoning, intellectual honesty/integrity and culture right.

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