

CAPCO

Beyond compliance

Stronger culture and resilience
through behavioral risk management

Financial institutions are rich in models and metrics, but risk ultimately crystallizes in human decisions. The next headline loss will not come from a spreadsheet but from capable teams making predictable mistakes under pressure.

In this article, we reframe risk around real decision-making under conditions of stress and distorted incentives, drawing on recurring patterns observed across global financial institutions.

We will:

- examine why controls break down in practice
- review the regulatory shift toward behavioral evidence
- highlight hidden vulnerabilities, such as misaligned incentives, groupthink, normalization of deviance and diffused accountability.

We also outline a practical roadmap showing how:

- behavioral drivers can be linked to value-at-risk
- incentives and challenge mechanisms can be redesigned
- behavior can be measured through indicators, diagnostics, analytics and scenario testing.

We conclude with practical tools to help firms build cultural resilience, and detail how Capco can support you to accelerate this shift.

For decades, financial institutions have anchored their risk strategies in data-driven models: value at risk, capital stress testing, regulatory ratios and other statistical tools. Yet, as reliable as these tools may seem, models do not panic in a market crash. Dashboards might flag exposures, but it is human decision-making which is shaped by context, stress and cognition that determines how risks unfold.

High-profile market failures over the past two decades, including major trading losses, fund collapses and the 2008 global financial crisis were not simply the product of statistical blind spots or flawed assumptions. They were fundamentally failures of mindset. Overconfidence, herd behavior and wilful blindness to escalating risks were consistent factors that shaped these crises. Sophisticated models were in place, but a model is only as useful as the inputs it is fed and the human judgment behind its output.

The real-world complexity of decision-making

Traditional economic models assume that individuals act rationally to maximize outcomes. However, in real-world scenarios, choices are rarely straightforward. They are shaped by incomplete information, emotional pressures and social influences.

Take a simple example: a Strava running challenge. You may set a clear goal, such as completing a specific distance or time, but unexpected factors, such as fatigue, uneven terrain or even encouragement from onlookers, can impact your decisions mid-race. Behavioral science helps explain such deviations, showing they often follow predictable cognitive patterns:

- Overconfidence bias: attempting a challenging route without preparation, assuming past success guarantees results
- Herd mentality: following others onto a slower path, without questioning if you know the shortest route.

In financial services, the same dynamics are pervasive. Decision-makers must navigate competing goals, group pressures or contextual uncertainties. Behavioral science reveals these underlying drivers and helps mitigate errors caused by predictable, bias-driven behaviors.

Behavioral science in financial services

In financial services, risky behavior often stems from behavioral undercurrents that are central features of human decision-making. The very structure of financial markets depends on behavioral unpredictability. If participants behaved with perfect rationality, there would be no risk premiums, no arbitrage, no inefficiencies to exploit.

Risk models aim to optimize risk-reward profiles and put safeguards in place to contain disruptive events. Behavioral science does not replace but explains crucial gaps in these models. For example, why traders double down on losses

instead of cutting their exposure, why executive teams diminish red flags in favor of comfortable narratives, or why risk governance controls often suppress dissent even when a robust challenge could prevent misconduct.

Behavioral science in the form of behavioral risk takes abstract risks such as 'conduct risk' or 'cultural drift' and makes them measurable, observable and actionable. By integrating it into risk management, institutions can proactively explore how human behaviors influence risk scenarios under uncertainty or pressure and help shape a healthier culture.

Regulators are paying attention

Regulators have recognized the interplay between behavioral dynamics and emerging risks.

The UK's Financial Conduct Authority (FCA) has embedded behavioral economics into its supervisory and policy approach, using behavioral analysis and testing to understand how firms' communications and product design influence consumer decision-making.¹

In the US, the Consumer Financial Protection Bureau (CFPB) has incorporated behavioral insights into consumer protection policies.² This has led to disclosure redesigns, simplified mortgage frameworks and testing of reminders or warnings.³

The Behavioural Economics Team of Australia (BETA) operates within the government to embed behavioral insights into policymaking.⁴

What once was soft science is evolving into regulatory scrutiny with compliance frameworks increasingly factoring in behavioral dynamics in areas such as operational resilience regulations.

The evolving risk landscape

The risk landscape is evolving rapidly. AI-driven decisions, hybrid workforces and geopolitical instability amplify uncertainty and complexity while introducing different risks and the potential for decision failures. These shifts demand an innovative approach to risk governance: from reactive control to proactive leadership, from managing outcomes to managing behaviors.

Organizations that embed behavioral risk into their risk frameworks can build more resilient cultures, anticipate conduct risk, strengthen oversight and respond to regulators' growing demands for accountability over behaviors, not just operational outcomes. Nowhere is this more

prevalent than in operational resilience, where regulators such as the FCA want to see tangible evidence of embedded behaviors over tick-box submissions.

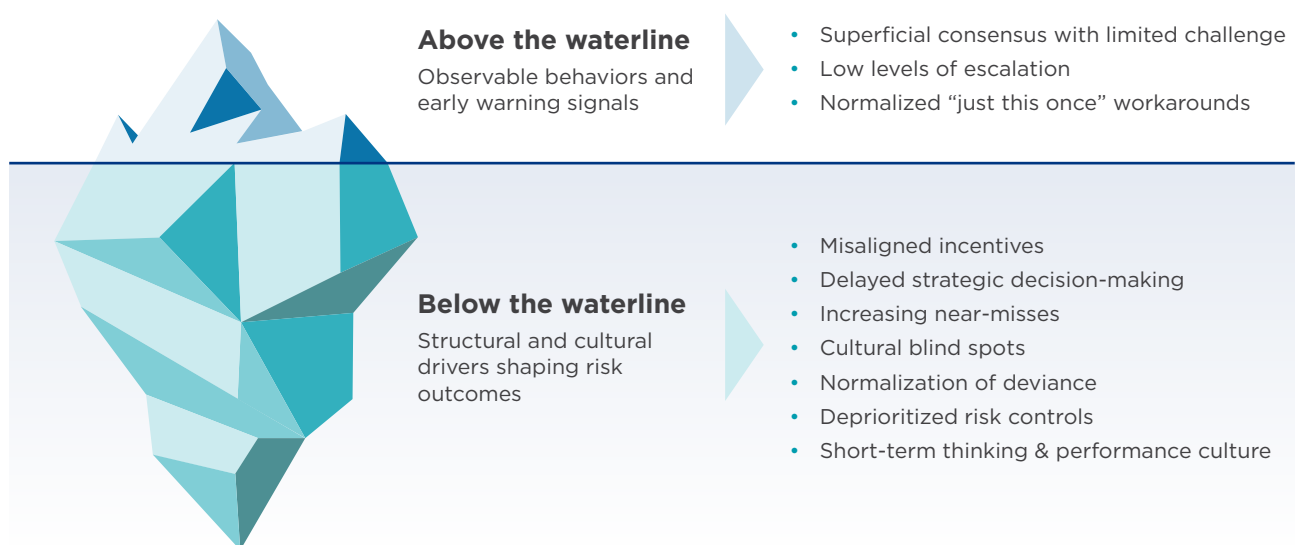
Behavioral risk management is no longer a luxury; it is a strategic necessity. Culture is a fundamental byproduct of behaviors. Building on our [previous paper](#) on the role of culture in operational risk and operational resilience, we will now explore how behavioral risk provides the tools to make culture observable, measurable and actionable, and in the process transform compliance from a reactive obligation into a proactive capability.

Addressing key behavioral risks, vulnerabilities and solutions

Once we acknowledge that human behavior shapes risk as much as models do, another question arises: why is behavioral risk still so hard to address?

In many organizations, the most powerful behavioral risks are also the most systemic and easy to overlook. Figure 1 below illustrates this through the 'iceberg effect', where visible outcomes often mask hidden behavioral depths.

Figure 1: The iceberg effect in behavioral risk



Source: Capco analysis

The systemic drivers below the waterline often remain latent until a control failure brings them into sharp focus. Four of the most common patterns are outlined below.

Cultural blind spots. Leadership teams often operate in environments where harmony is valued over constructive dissent. A lack of behavioral diversity (not just demographic, but cognitive) and overreliance on group norms and narrow decision-making scope, can weaken effective challenge. Over time, this dynamic weakens challenge, deepens blind spots and predisposes organizations to systematic decision errors.

Misaligned incentives. Misaligned performance measures often reward behaviors that run counter to stated organizational goals. For instance, front-line teams incentivized by transactional volume might deprioritize escalation of 'grey area' issues, even in high-stakes contexts such as anti-money laundering (AML) monitoring.

De-prioritization of risk controls. Both in politics and day-to-day execution, pragmatism often trumps processes or rules. Minor deviations from protocols, when left unchallenged in the name of efficiency, can erode standards over time. This is a phenomenon known as 'normalization of deviance'. Such shifts can go unnoticed in dashboards or KPIs, but they ultimately lay the groundwork for significant control failures.

Short-term thinking and performance culture. Performance systems often reinforce this disconnect. When performance systems focus success on quarterly growth, cost optimization or shareholder returns, long-term reflection and foresight tend to lose out. Teams and leaders are often reluctant to highlight uncomfortable questions or inefficiencies that may not yield immediate results; this undermines sustainable decision-making in favour of expediency.

Challenges in leadership engagement

Despite a growing recognition of these issues, behavioral risk remains difficult to embed meaningfully into organizational frameworks. The key barriers include:

- Leadership acknowledges the importance of culture or conduct, but lack practical structures to facilitate measurement or oversight outside of isolated cases or events.
- Behavioral risk feels abstract. It resists ownership and often raises uncomfortable questions about leadership style, team dynamics or power structures.
- Behavioral risk rarely screams for attention when market volatility, regulatory change or operational pressures dominate attention. The subtle drivers of human behavior often fall by the wayside. It is the 'quiet risk' that gets ignored while everyone rushes to put out the obvious fires.

A roadmap for board-level buy-in

Step 1: Capture leadership attention

The fastest way to engage senior leaders is to demonstrate how behavioral failures translate into financial, reputational and regulatory costs. Recent history offers many examples.

At a large US retail bank, thousands of fake accounts were created because employees feared missing sales targets.⁵ The behavior was widespread but also entirely predictable in a culture that rewarded numbers over ethics. Controls existed but failed to address root causes for years.⁶

At a major UK banking group, hundreds of millions of pounds in cash were deposited and laundered by a single customer over five years despite clear red flags: suspicious behavior at branches, musty-smelling notes and Scottish banknotes deposited across England. Staff raised concerns that went unaddressed, while the bank's systems compounded the failure by misclassifying some cash deposits as cheques which led to the signs being downplayed. The result was a criminal conviction and a substantial nine-figure fine.⁷ The failure was a perfect storm of ignored warnings, automation bias and diffused accountability.

Beyond looking at individual players, there are industry-wide systemic issues to consider. In

October 2025 the FCA opened consultation CP25/27, proposing an industry-wide consumer redress scheme for historic motor finance commission arrangements (including Discretionary Commission Arrangements (DCAs)).⁸ The consultation closed on 12 December 2025, and the FCA has since confirmed that the complaints-handling pause will be lifted on 31 May 2026, shifting from 31 July as originally planned.⁹

This is not the first instance of mis-selling proliferating across an entire marketplace. The UK financial sector has seen similar patterns before: Payment Protection Insurance (PPI) became one of the largest redress exercises in UK history. Banks set aside tens of billions of pounds for compensation claims, and interest-only mortgage practices were significantly restricted after widespread concerns that advisors had failed to properly assess whether borrowers held suitable repayment plans for the capital balance.¹⁰

Such episodes demonstrate that behavioral drivers, including misaligned incentives, normalization of weak practices and insufficient challenge, can escalate from localized issues to systemic, industry-wide failures when left unchecked. We set out some further examples in Figure 2.

Figure 2: Firm failures through a behavioral lens¹¹

Firm	Year	Headline	Impacts	Sample of key behavioral biases and failure modes
Large European investment bank	2021	Prime brokerage and counterparty risk control failures	Several billion-dollar loss, collapse of Greensill exposure, leadership overhaul, reputational damage, several million-pound PRA fine	Authority bias: Deference to leadership and trusted counterparties suppressed challenge and escalation, contributing to the underestimation of high-impact risks.
Universal bank	2018	AML failures in regional operations	Several billion-dollar fines, senior leadership resignation, cross-border investigations	Motivated blindness: Financial incentives and local performance pressure drove the deliberate ignoring of clear AML red flags.
Major UK retail and investment bank	2021, 2023	Senior executive misconduct	Senior leadership resignation, several million-pound FCA fine, conduct scrutiny	Authority bias: Reliance on senior executive judgment overrode skepticism and due diligence, reducing challenge to reputational and conduct risks.
European payments company	2020	Accounting fraud and fictitious assets	Insolvency, Senior leadership arrest, regulatory overhaul in Germany	Confirmation bias: Management selectively interpreted information to reinforce a preferred narrative, dismissing contradictory evidence and delaying corrective action.
Global universal bank	2012	AML failings enabling cartels	Several billion-dollar fine, compliance monitoring	Normalization of deviance: Repeated exposure to misconduct without immediate consequences reduced ethical sensitivity, reframing compliance as a procedural exercise rather than risk management.
Global universal bank	2010s-20s	Multiple market conduct failures	Billions in fines, leadership turnover, regulatory scrutiny	Moral disengagement: Persistent misconduct was normalized through rationalization, siloed accountability and the treatment of fines as a cost of doing business.
Global wealth and investment bank	2019	Cross-border tax evasion	Several billion-euro fine, reputational harm	Wilful blindness: Deliberate avoidance of scrutiny into lucrative practices despite clear legal and ethical risks.
Global investment bank	2020	Bribery and corruption scandal	Several billion-dollar fine, executive sanctions	Overconfidence bias: Strong belief in institutional expertise and control capabilities led to the underestimation of ethical and governance risks despite clear warning signs.

Across these examples, one theme is consistent: these were not failures of process but rather failures of behavior.

They also reveal how behavioral weaknesses can undermine the three lines of defence. The first line is accountable for managing conduct and behavioral risks in business activities and for operating effective controls. The second

line defines the policy framework and provides oversight and challenge over how effectively the first line manages those risks. The third line independently assures the board and senior management that the overall framework and control environment are effective. When behavioral norms drift, each line becomes less effective, allowing issues to escalate long before control failures become visible.

Step 2: Deliver client solutions

Leaders value solutions, not just diagnoses. Staying ahead of regulatory and cultural expectations requires targeted, practical interventions.

Rewire the system, not just the rules. Most people openly admit to not having fully read or understood contracts they sign.¹² Expecting people to engage deeply with behavioral risk policies hidden in SharePoint is optimistic at best. To change behavior, change the decision environment.

- **Realign incentives and design friction:** Revisit KPIs and reward structures to promote prudent decision-making and escalation; introduce deliberate pause-points such as 'red-tag' reviews, pre-mortems or second-line challenge gates to 'catch' bias before it compounds.
- **Engineer cognitive diversity and challenge:** Mandate structured dissent such as rotating challenge roles, independent reviewers and cross-functional debate to reduce authority bias and groupthink.
- **Embed behavioral insight in product and conduct design:** Map consumer journeys for bias and confusion by reframing defaults, disclosures and timing to reduce foreseeable harm.
- **Audit digital conduct and interface design:** Identify 'dark patterns' or manipulative defaults that undermine fair consumer choice.

Bring behavior into the data. The absence of visibility does not equate to the absence of risk; it means that either you do not know what you are looking for or you do not have the tools to see it. These principles can hold true for behavioral risk. Once behaviors are made measurable, leaders can see drift early, compare patterns across teams and intervene before small issues escalate.

AI now makes this even more powerful: most behavioral signals leave a data trail, and advanced analytics can surface emerging pressures, weak challenge or misconduct indicators long before they appear through traditional monitoring. Predictive flags also increase accountability by making inaction more observable and attributable. However, to generate these insights, we need data.

- **Proactive use of behavioral indicators:** measure escalation lag time, challenge frequency and tone of decision discussions; combine them with traditional KRIs to expose early drift
- **Internal behavioral supervision:** conduct internal 'culture reviews' modeled on supervisory culture diagnostics, assessing leadership tone, accountability and incentive alignment
- **Integrated behavioral analytics and surveillance:** apply sentiment and linguistic analytics to identify complacency, collusion or pressure indicators within internal communications
- **Scenario planning with behavioral dynamics:** extend stress testing to model how human reactions such as herd behavior and overconfidence could amplify systemic risk.

The greatest teacher is failure. Failure is the most reliable source of behavioral insight. When controls break down, they expose not just process weaknesses but the human assumptions, incentives and decision patterns that preceded them.

- **Scenario-based behavioral training:** use simulations that replicate real-world uncertainty and time pressure, revealing decision traps such as confirmation bias or loss aversion; resilience scenario testing can be an excellent source of learning
- **Behavioral leadership coaching:** train leaders to recognize and correct for overconfidence,

optimism bias or moral licensing and to model curiosity over certainty

- **Behavioral framing of incidents:** review breaches, near-misses and decision drift through a behavioral lens to understand the ‘why’, not just the ‘what’ (this behavioral insight enables a shift in risk event management, from fragmented remedial actions toward the proactive design and strengthening of key controls)
- **Creating a behavioral feedback loop:** integrate insights from incidents, analytics and training into governance and performance reviews to reinforce behavioral awareness.

As financial institutions face increasing complexity and scrutiny, behavioral risk offers a practical and measurable way to strengthen risk culture, resilience and the quality of decision-making under real-world pressures. Making behavioral drivers visible allows firms to detect early drift, reinforce challenge and demonstrate the behavioral evidence regulators now expect.

Embedding behavioral insight into governance, incentives and day-to-day decision environments is not an additional layer of compliance but a strategic capability that supports more consistent oversight, better decisions and more resilient outcomes.

The opportunity now is to move from talking about behavioral risk to actively operationalizing it into how organizations lead, supervise and manage risk. This ensures culture becomes a source of strength rather than an unexamined vulnerability.

How Capco can help

Capco's Behavioral Science practice helps financial institutions evolve from awareness to assurance. Drawing on experience delivering culture audits, behavioral diagnostics, decision-making simulations and Consumer Duty redesigns across global banks, our approach is grounded in real-world practice.

Our team works in partnership with clients to co-create solutions, embedding behavioral insight into governance, risk and cultural frameworks in a way that is practical, measurable and owned by the organization.

We provide firms with the means to measure behavioral risks, tested controls to mitigate them and the expertise to make those changes sustainable. In doing so, we help firms not only meet regulatory expectations, but build stronger cultures, better decisions and better outcomes.

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About Capco

Capco, a Wipro company, is a global management and technology consultancy redefining transformation across the financial services and energy industries. Capco leverages the power of AI and our deep domain expertise to help our clients move faster, make smarter decisions, and drive greater impact. Our award-winning Be Yourself at Work culture and diverse talent drive bold, forward-thinking ideas and lasting change.

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