This article was first published in the Journal of the Australian and New Zealand Institute of Insurance and Finance (ANZIIF) Vol 35. Issue 4

Culture, Risk and ICAPP

By John Dawson - BA - Fellow ANZIIF - Principal - Dawson McDonald Consulting

There is a long and continuing record of organisations with sound risk management frameworks suffering enormous reputational damage and serious loss of capital – in some cases leading to business collapse. The purpose of this article is to examine the impact that organisational culture can have on risk management, including results of field research we have conducted, and to suggest some factors that are important in creating a strongly positive risk culture.

Risk management is most effective when the process of thinking about managing risk is embedded in organisational culture. The Internal Capital Adequacy Assessment Process (ICAAP) requires astute management of risk by insurers and all insurers will be required to meet the provisions of ICAAP, scheduled for implementation on 1 January 2013.

While the ICAAP Standard does not mandate a risk culture, it certainly invites focus on what is required for a positive risk culture through Operational Risk Charge. ICAAP requires ñadequate systems and procedures to identify, measure, monitor and manage the risks arising from the regulated institutionõs activities on a continuous basis to ensure that the capital is maintained at a level consistent with the regulated institutionõs risk profile and the Boardõs risk appetiteò. The Standard sets out various risk charges to be taken into account in assessing capital adequacy. One of these is Operational Risk Charge which ñrelates to the risk of loss resulting from inadequate or failed internal processes, **people** (my emphasis) and systems or from external eventsò.

The vast majority of sizeable organisations have risk management frameworks, policies and procedures in place, to varying levels of sophistication, and yet there seem to be almost weekly reports of situations where the organisational culture has overwhelmed the risk management strategy. Consider this classic case from the aviation industry: The Age newspaper reported on 8 March this year that a Melbourne-bound Boeing 737 and a business charter jet had been put on a head-on course by Defence Department air controllers overseeing Newcastle Airport in New South Wales, which handles military and civilian aircraft. The Virgin pilots saw the business jet flash past in front of them, but the business jet pilots said they didnõt see the Boeing 737.

The report continued that an Australian Transport Safety Bureau investigation of this 2011 incident found training deficiencies and also that an automated near-miss alert had been disabled on the controllersõ screens because military aircraft movements - particularly formation flying - set off too many false alarms. Itõs hard to imagine that the Defence Departmentõs Risk Management Framework provided for the near-miss alert to be turned off because of false alarms, so this looks very like another case where operational culture has totally bypassed risk management protocols.

Loss of life is not such a risk in the financial services sector, but loss of reputation and capital certainly is, as these examples show (naturally those organisations that are still functioning have acted, or will act, to reduce the risks of their reoccurrence).

B**arclays:** American regulators have accused Barclays of lies, deception and manipulation of the London Interbank Offer Rate (LIBOR). Substantial fines have already been paid, reputation has been seriously damaged and a tidal wave of litigation against the bank is building.

Securency: Reserve Bank Governor Glenn Stevens commented on the RBAôs currency maker, Securency, failing to adequately guard against bribery. Mr Stevens claimed that ñon paperò the companyôs anti-bribery policies were robust.

ñPolicies that look very good on paper and look very strong and had all the right checks and balances and due diligences and so on, had not been implemented properly,ò The Age newspaper reported.

UBS: This Group was forced to enter an enforceable undertaking with the Australian Securities & Investment Commission and to offer compensation to several hundred clients, after failing to provide Statements of Advice. In the undertaking the Group admitted that their ñmanagement and advisers in its wealth management arm failed to take seriously their obligations under legislation to provide the statements to their clients, failed to have proper procedures in place to ensure compliance and failed to ensure staff had adequate compliance trainingò, reported The Australian Financial Review.

NAB: This bank suffered a loss of several hundred million dollars and heavy reputation damage due to rogue trading activities. Like all major banks it had a risk management framework, policies and procedures and a considerable number of staff employed in risk management roles. What became clear in the subsequent investigation was that bad news was concealed from senior management and the Board ï another cultural failure. The culture of NAB was one to focus on ógood newsô and the Board was not informed of important issues.

HIH: The Honourable Justice Owen in his report of the Royal Commission into the catastrophic failure of insurer HIH commented on the culture of the organisation:

ñA cause for serious concern arises from the groupôs corporate culture. By ócorporate cultureô I mean the charisma or personality -sometimes overt but often unstated - that guides the decision-making process at all levels of an organisation é Risks were not properly identified and managed. Unpleasant information was hidden, filtered or sanitised, and there was a lack of sceptical questioning and analysis when and where it matteredò.

An organisation may have an excellent risk management framework, policies and procedures but this system will only function as intended if the organisational culture supports it. If the cultural attitude to risk in the IT, finance or other departments of an organisation is poor, that organisation is exposed to adverse consequences, even though its risk management system may be comprehensive.

Culture is driven by the values set and demonstrated in action by the leadership group, by the practices that flow through the organisation as a result and by the influence of these practices on the behaviours of individuals.

Looking at the Risk Culture Chain (Fig. 1), would you say that Correct Risk Treatment and Actual Risk Treatment are identical in your organisation, or does the Actual sometimes deviate? If so, culture is the most probable cause.

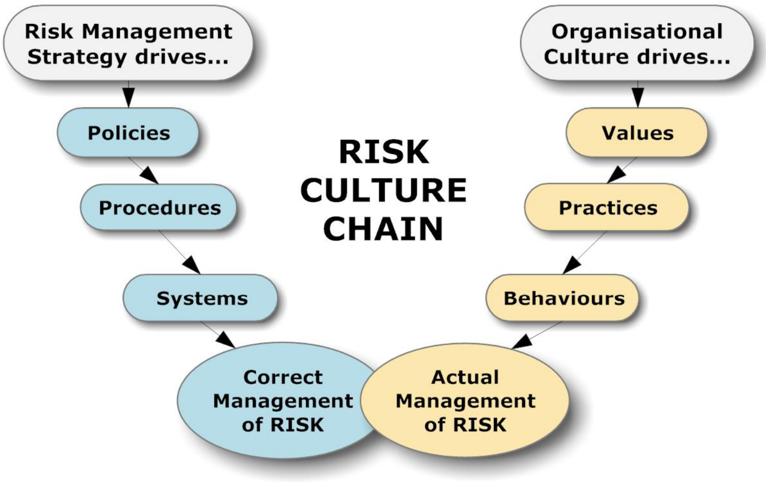


Fig 1 jer! If Culture is not fully aligned with Risk Strategy, Culture wins - you lose.

© Dawson McDonald Consulting

Culture eats strategy for lunch" although a cliché is nonetheless true in relation to the management of risk

Examples of culture increasing risk are:ï

- Strong pressure to achieve targets, leading to cutting corners or risky deals and alliances.
- Resistance by senior executives to being given bad news. The messengers are accused of not being team players and/or pressured to be silent.
- Internal competition for resources, recognition or promotion, which can also stop information sharing across the organisation.

Among our clients, we often see management pay great attention to the process side of the Risk Culture Chain, because the matters that lie there can be subjected readily to measurement but often little focus is given to the culture side. There can be many reasons why culture receives insufficient attention in relation to risk, including:

- Perceptions that if overall organisational culture is sound this will also deal with culture in relation to risk.
- Training line managers in risk management framework, policies and procedures is seen as sufficient.

The Risk Management Standard AS/NZS ISO 31000:2009 makes particular reference to the need to recognise ñthe importance of taking human and cultural factors into accountò.

If an organisation has a culture in which people at all levels think about managing risk as part of *"how things get done around here"* then the ability of that organisation to successfully manage risk (both positive and negative) will be significantly greater than in an organisation where risk is treated only as a compliance issue, that is, imposed from above in order to meet statutory or legal obligations.

Increasingly, senior executives in both the private and public sectors are being required to report on the effectiveness of the organisationôs management of material risks. Senior executives submitting those reports can be far more confident of the robustness of their attestations if they have a culture in which thinking about managing risks is part of *"how things get done around here"*.

RISK AND CULTURE INAUSTRALIAN ORGANISATIONS

Dawson McDonald conducted a national survey to examine cultural aspects that might affect the management of risk. A total of 218 executives completed this survey. Respondents came from over 180 organisations across 18 industry sectors, including government, financial services, mining, manufacturing, construction and education. 40% employed more than 1,000 staff and 44% employed 100ï 1,000 staff.

Surprisingly, only 43% of respondents were confident that their organisations were effective at managing risk. The survey also showed that in four out of ten organisations, thinking about managing risk is not embedded in the culture but is an imposition. The two questions were:-

- In my organisation risk management is mostly perceived as a ñtick the boxò exercise completed at regular intervals for audit/ compliance purposes or another task that distracts attention from the real work: 42% chose this.

- When decisions are made in my organisation, the risk management implications are carefully considered: 49% chose this.

Which of these two responses would your staff choose?

It is encouraging that almost half of the respondents believe that risk management is carefully considered in decision-making, but also disturbing that 49% were aware of people in their organisations taking shortcuts to get things done, and so creating unnecessary risks.

The results of our survey showed that failure to embed thinking about managing risk in the culture is also reflected in:ï

- Only five out of ten organisations give the people directly responsible for risk management ñthe authority to act and the commitment/support of our management teamò.

- Four out of ten have poorly resourced risk management functions.

- Only one in four is positive that all staff have been well trained in identifying and managing risks.

- Overall, 77% believe it is important to have a risk culture supportive of the organisationôs goals and its people, but only 51% believe their current culture achieves that.

Clearly there is much scope for improvement.

The Risk Culture Chain shows the importance of the values set and demonstrated in action by the leadership group. Culture is driven from the top and the key principles are often set out in a Statement of Values (see Fig 2).

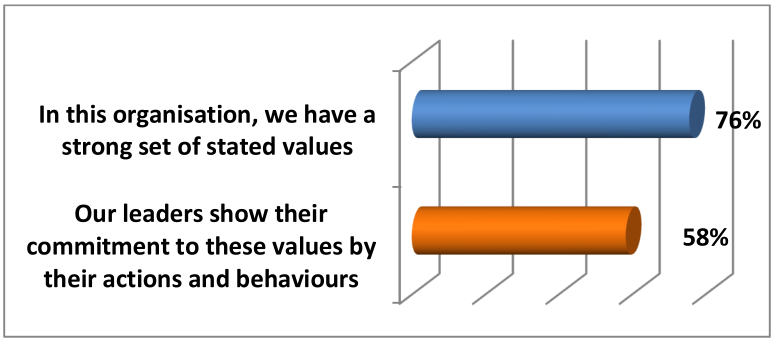


Fig 2

These scores related to the overall values of organisations, not just those related to risk. Leaders clearly have a credibility gap in many of these organisations between their words and actions. This disparity makes it much harder to build a positive culture.

ARE ORGANISATIONAL CULTURE AND RISK CULTURE IDENTICAL?

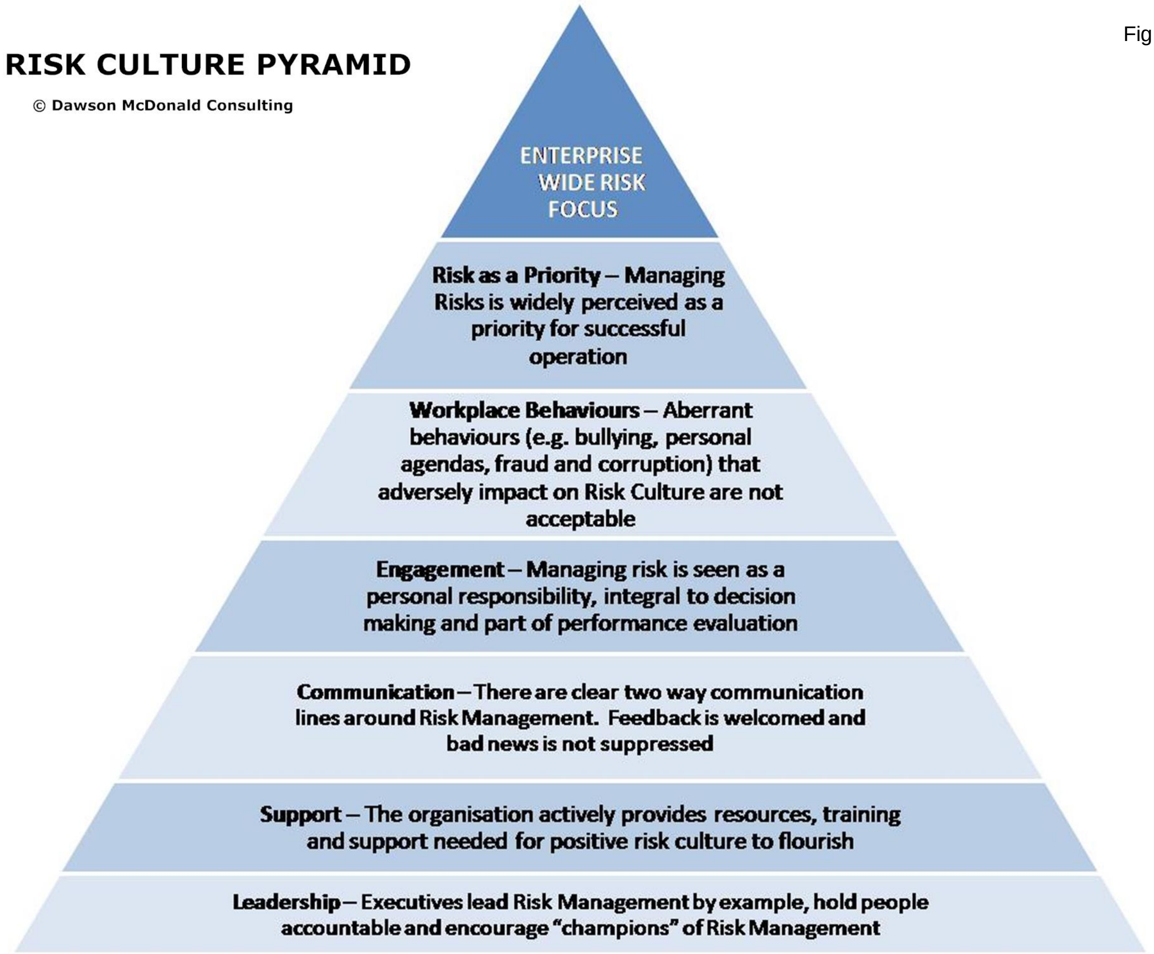
We facilitated a Round Table discussion for senior executives in Australia about the impact of organisational culture on the management of risk. There was broad agreement that culture in relation to risk is driven by the overarching organisational culture. We agree that itôs not possible to have a sound risk culture if the overall organisational culture is unsound.

However, we have seen many examples of organisations that have a positive culture overall and yet do not have a sound risk culture. This is especially true in organisations where the management of risk is seen by many as a compliance issue rather than a means for guiding business decisions.

BUILDING A POSITIVE RISK CULTURE

Without the right ñtone at the topò a positive risk culture will never be achieved. The factors we have identified, through our research and field work with clients, as being essential to achieving a positive and effective risk culture are illustrated in the Risk Culture Model in Figure 3. In our experience, where staff at all levels are strongly positive about each of the steps in the Risk Culture Model, the executive team will also show confidence that risks are being well managed and staff scores will compare favourably with good practice benchmarks.

Fig 3



Recent audits we have run for private and public sector clients to assess organisational attitudes to managing risk, highlight some recurrent areas for improvement:

- lack of recognition for ñchampionsò of risk management
- poor liaison across silos to collaborate on risk management
- need for feedback to staff on progress in managing risks
- organisational politics interfering with the allocation of resources
- lack of shared understanding of the organisationôs risk appetite
- people railroading decisions through regardless of cost or risk to the organisation
- risk management being seen as a ñtick the boxò exercise for compliance or a ñdistraction from the real workò by about one third of employees.

THE ROLE OF RISK MANAGERS

The role of the Risk Manager is obviously critical in helping to build and sustain a positive risk culture. However the prime responsibility rests with the executive team and line managers. The Risk Managerõs role is similar to that of a Chief Financial Officer - the CFO monitors the management and use of funds throughout the organisation, provides guidelines and issues requirements for corrective action, but responsibility for achieving P & L targets rests with the line managers, not the CFO.

The Risk Manager must play a similar role in guiding and supporting line managers. Most risk managers are not vested with the same level of authority as the CFO. To overcome this, risk managers must have strong skills in persuasion and influence and be able to translate risk management into the language of the line managersô business units.

ORGANISATIONS AS HUMAN PERFORMANCE SYSTEMS

One of our international colleagues, Dr Donald Tosti, describes organisations as ñHuman Performance Systemsò. Premises, equipment, technology, funding and other resources are all enablers to support the functioning of the Human Performance System and culture, or ñthe way a group of people prefers to behaveò, is the glue that binds that system together.

Both ICAAP and the Operational Risk Charge, together with AS/NZS ISO 31000:2009, refer to the importance of human and cultural factors in the management of risk.

Insurers will no doubt take great care in building and testing their Internal Capital Adequacy Assessment Process to ensure that risks are maintained within tolerable limits. Savvy insurers will pay equal attention to building and sustaining a positive risk culture, where every staff member thinks of managing risk as part of his or her personal responsibility.

For further information or to find out more about our Risk Culture: An Assessment of Organisational Attitude to Risk, please contact:

John Dawson
Dawson McDonald Consulting
Ph. +61 3 9602 4858
info@riskculture.com.au
www.riskculture.com.au