Headline-risk events and catastrophes ranging from Rupert Murdoch's News Corp. scandal (above) to the Deepwater Horizon spill (center) have boardroom and governance consequences — if not causes.

Science of Culture

Can risk culture be taught? There is no lack of advice, methodologies, frameworks and tools for corporations seeking to instill risk-aware values and better governance.

By Katherine Heires

The News Corp. phone hacking scandal that flared this summer, and that caused founder and CEO Rupert Murdoch to be summoned before the British Parliament, brought the term "corporate culture" into the media mainstream, along with commentaries about apparent breakdowns in governance, risk management and other safeguards against costly or wrongful behavior. Similar lapses have been exposed in the aftermath of headline-making disasters such as those of the Fukushima nuclear plant in Japan, the Deep Horizon oil rig in the Gulf of Mexico and the Massey Energy mining accident in West Virginia.

That same type of criticism hit home in the aftermath of the financial crisis. The Institute of International Finance, among many others, cited cultural failures, and specifically those of risk culture, as a leading cause of the credit and liquidity crisis of 2008. Switzerland-based UBS, in an October 2010 accounting to shareholders of its crisis-period losses, admitted to "organizational shortcomings and the lack of adequate controls inside the bank." As a result, many provisions in post-crisis legislation and regulation were intended to tighten governance and risk management principles and standards.

Now management science is having its day. Corporate consultants have sought to analyze, assess and gain a better understanding of culture and its essential elements. They are delving into how organizations can best build and embed effective "corporate risk cultures" or "risk management cultures" that discourage negative, harmful or illegal behaviors while also having a positive effect on the business.

Such efforts to define and systematize risk culture have been undertaken despite the fact that many companies do not even use the term when addressing operational and behavioral problems. Risk management experts, however, believe that risk culture, in the sense of how well organizations are equipped to deal with problems, competition and business pressures on a day-to-day basis, is ripe for further study and analysis.

New York-based governance research firm Governance Metrics International (GMI), for example, has more than 100 corporate clients interested in its ESG – environmental, social and corporate governance – performance ratings, which to some degree take risk culture into account, says CEO Jack Zwingli.

"There is a growing belief among institutional investors that they need to look past financial results and examine corporate governance practices, including the risk management practices of the board and whether or not they encourage inappropriate risk taking," says Zwingli. GMI's analysis is designed to determine what corporations may have the riskiest cultures and, thus, the greatest probability of facing litigation or public embarrassment *a la* News Corp.

Characteristics of Culture

"It is rare that clients come to us and say they need or want to change their risk culture," notes Chris Thompson, North American lead for risk management consulting services at Accenture in New York. "It is more common for people to ask for assistance in how to be better at taking risks or how to be better able to take on even more risks." The term "risk culture," Thompson says, is more common in the context of mergers and acquisitions that require two cultures be melded. For those needs, Accenture offers a cultural assessment tool kit for companies coming to grips with their risk appetite and risk culture.

Photos by Polaris

COVER STORY

Cultures by the Books

By Katherine Heires

Two noteworthy business books published this year – "Money and Power: How Goldman Sachs Came to Rule the World," by William D. Cohan; and "Fatal Risk: A Cautionary Tale of AIG's Corporate Suicide," by Roddy Boyd – convey important lessons on the effectiveness of a strong risk culture and, conversely, what happens when it is lacking.

A former Wall Street banker, Cohan tells *Risk Professional* his research turned into a study of Goldman's risk culture and practices, because "the whole culture of the firm is focused on the handling of risk." He ascribes that to its heritage as a private partnership whose partners were liable, up to their entire net worths, for any missteps or risky behavior.

"The only way these guys could make money and get a return on their investments was if the firm did not blow up, and this meant taking profitable, yet always prudent risks, as opposed to dangerous ones," Cohan says.

In a partnership structure, risk managers function differently than they do at other Wall Street firms: They are empowered, taken seriously and have a direct reporting line to the CFO. "At other firms, the revenue generators have the ability to ignore risk managers or to shut them down, but at Goldman, that could never happen," says Cohan. He adds, "Craig Broderick, the CRO, is hugely empowered, and the 'VaR police' has huge authority."

Ability to Recover

Things did occasionally go very wrong, but, Cohan says, "As poor as they were at times at taking risks, they were even better at getting themselves out of a risky situation." One such example in the book is the 1970 collapse of the Penn Central Transportation Co. Goldman had sold upwards of $225 million of the rail corporation's commercial paper, but in 1969, four investors sued Goldman in federal court for more than $23 million, half of the firm's worth at the time. The allegation was that Goldman, as a dealer, should not have been promoting a questionable product and should be held responsible when the company whose notes they were handling got into financial trouble.

Cohan asserts that the two years during which Goldman sold Penn Central commercial paper were a mirror image of what it did with the Abacus synthetic collateralized debt obligations 40 years later, which cost Goldman $550 million in a settlement with the Securities and Exchange Commission. Even as Penn Central's financial situation deteriorated, Goldman kept on selling and "did not tell clients that [Penn Central] was going down the tubes." The firm ultimately signed a consent decree, without admitting or denying any wrongdoing, and was able to continue to act as a dealer.

The lasting lesson? "They were very astute risk managers for themselves, which is why they came out of the financial crisis in much better shape than anyone else," says Cohan.

"Fatal Risk" tells a different tale. As author Boyd explains it, American International Group CEO Hank Greenberg's approach was to excessively micro-manage risk-taking and money-making practices. He was the ultimate arbiter of what was and was not acceptable, as opposed to distributing the responsibilities and risk functions among his managers.

Numbers Obsession

Boyd applauds Greenberg for being risk-savvy and for not having layers of bureaucracy between him and his CRO and the rest of the risk team. His flaw was an obsession with a 15% return-on-equity target for each business unit, which was inimical to legitimate and multifaceted risk management efforts in place. AIG went so far as to have a detailed plan for survival of a nuclear attack on New York City.

Greenberg's "numbers-driven culture . . . became a big problem," explains Boyd. The appropriate message to AIG employees and investors should have been that years of bounty would be offset by others when "when 15% on equity is not doable, either intellectually or on a sound risk basis," says Boyd in an interview.

He adds, "As an insurance provider, AIG was built to be the one thing that did not fall down during a thousand-year storm. As it turned out, they sabotaged their own foundations with nightmarish investments made through their securities lending and financial products units." It is a risk-culture tragedy that was compounded by poor decision-making after Greenberg's departure, all chronicled in "Fatal Risk."

"When we talk about risk culture, we are talking about firms that know how to take the right amount of risk so that while they are avoiding bad things happening, they are also driving innovation," says Thompson. "Firms with effective risk cultures are taking the right amount of risk," and in a balanced way.

In advising clients, Accenture defines risk culture in terms of six key attributes. Among them are: the degree to which accountability for risk management is clearly defined, the clarity of responsibility for risk management tasks, and the level of understanding of compliance with regulations and procedures; and the degree to which risk management is integrated into all activities, including resource allocation, planning, budgeting and measurements as well as documentation, procedures and processes.

Third is the degree to which leadership for risk management is clear or visible: Are leadership skills cultivated? Is there openness and communication about risk management issues? The fourth attribute is the degree to which risk management is learning-driven, including whether or not learning about risk issues is facilitated and a questioning attitude encouraged.

Accenture's fifth attribute is the degree to which there is a clear process for effective risk management: Does the whole firm have risk awareness? Is there a fear of reprisals that might have a chilling effect on employees? The sixth is whether or not incentives are geared toward the best interests of the enterprise: Is compensation aligned with the risk strategy? Does risk management have a role in approving risk-adjusted compensation measures? Do incentives promote long-term, risk-conscious behavior?

Thompson concludes by saying, "At all times in your business, you want to take the right level of risk and make sure that when you are taking risks you are doing so in your areas of core competency. That is what many companies have gotten wrong of late and hope to redress."

Post-Crisis Response

As executive vice president of governance, risk management and compliance advisory services at Thomson Reuters, Philippe Carrel has spent the last three years meeting a great many CFOs and CROs in a variety of fields and advising a broad range of companies on how to improve their risk management efforts post-crisis. The questions he is asked are diverse, but, to Carrel, the road to improvement converges inevitably on risk culture. His book on the subject, "The Handbook of Risk Management: Implementing a Post-Crisis Corporate Culture," was published in 2010 by Wiley Finance.

To inculcate an effective risk culture, "you need to do what we did on the trading room floor," states Carrel, who is based in Geneva, recalling his experience as an options trader before becoming head of risk and trade management at Reuters in London.

"We had profit-and-loss limits and risk limits on a host of sensitivities," meaning that Carrel could rest easy as long as he had traded within his limits on any given day. But if something unexpected or disruptive occurred in the global markets, causing his open positions to suddenly go off their limits, when he would return the next morning, someone on the trading team would have known to take action, unwound the positions and addressed any risk issues as well.

"There was and continues to be a hierarchy of response and accountability regarding risk on the trading floor," Carrel explains. "This means if you are not there, someone else on the trading team will take care of the risk for you." In the post-financial-crisis world, this sort of "distributed risk" thinking, or "risk intelligence," needs to be applied throughout the entire enterprise, says Carrel, and the resulting risk management culture should only grow stronger and more effective over time.

"Risk management as we know it has ceased to exist, and it's time to think about the next generation," says Carrel. He considers pre-crisis risk management efforts to have largely failed; they produced helpful tools such as value-at-risk (VaR) assessments, but not true risk management.

"Risk was measured, estimated, documented, warehoused, and reported, but was it managed the way we manage a book of options as a market maker?" says Carrel. "No one was doing this."

Flexible and Customized

Carrel believes in firm-wide risk cultures that are flexible, customized and reflective of their respective risk appetites. This entails disseminating risk exposures and sensitivity to all groups and individuals who have responsibility for it, rather than keeping it to a siloed or business-line basis.

"Old-school risk managers will say my approach will create armies if not generations of rogue traders," says Carrel. But he believes that by making people accountable and responsible for the risk in their given business unit and empowering them to do something about risk when limits are breached, the entire enterprise – in any sector – will be better equipped to detect dangerous "gyrations" and move faster to correct them.

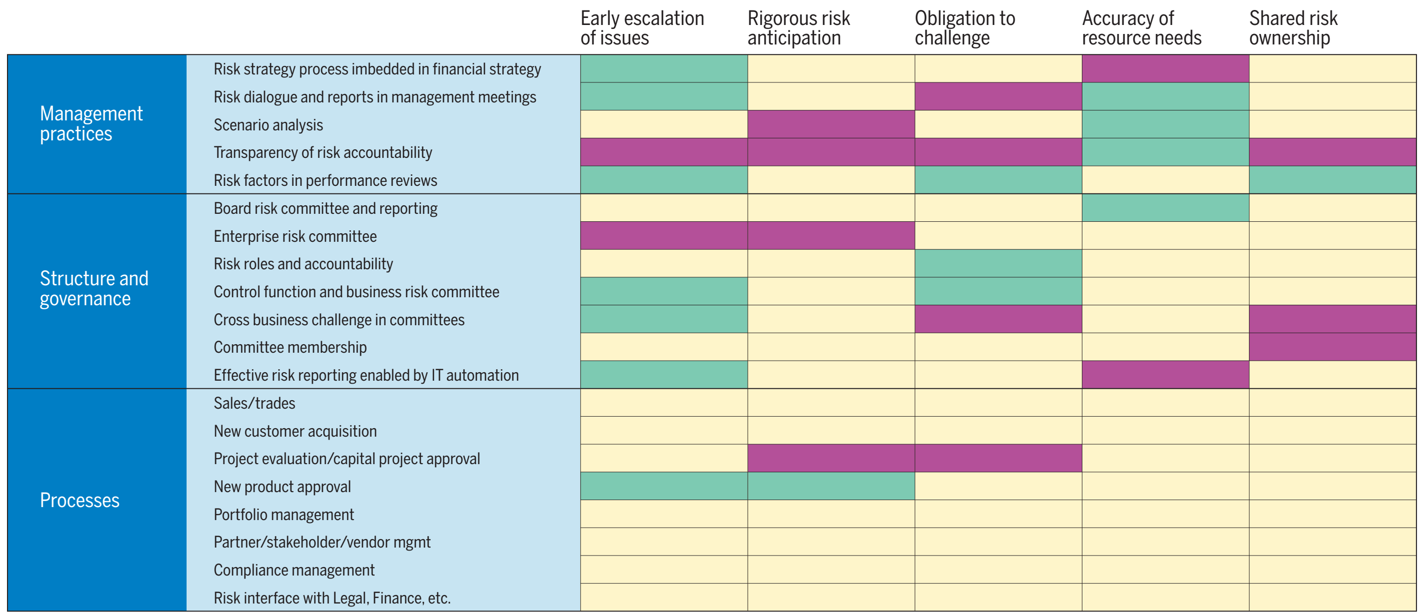
This approach requires identification of firm-specific risk factors and involves all people from all operating units participating in risk identifications, sensitivity assessments and valuations in a way that ensures that managers fully comprehend their units' comfort level with various risks. Ultimately, the process helps to instill and spread the values of responsibility and accountability.

"Transparency will eventually arise from the consensus created through this process," Carrel writes, adding that it will encourage firms to shift away from an unhealthy reliance on risk models and standardized risk-mitigation tactics, and toward greater use of scenario-based risk assessments that are more sensitive and attuned to a company's specific and often shifting risks.

Technology for the Purpose

Another key element is the development of what Carrel calls an "adaptive information workflow," which presents major challenges for a firm's information technology infrastructure:

COVER STORY



McKinsey & Co. sees a heatmap as an effective method of identifying areas requiring intervention.

It has to be designed to overcome the different and sometimes inconsistent processing methods serving various silos of information; it has to be able to compute the sensitivity of exposure from all sources under a single scenario; and when risk policies are translated into quantified risk targets for the various business units, the technology must be capable of sending triggers and alerts to the relevant unit managers, allowing them to react in real time to any unwanted or excessive exposures.

Where do risk managers fit in this picture? According to Carrel, when each business manager becomes a risk manager – not only in front-line settings, but also in the back office, senior management, legal and administration departments, production units and IT – the traditional mission of the risk management department evolves into fostering the culture of risk management, providing coaching and education on an ongoing basis to assist in the identification, quantification and mitigation of risks.

With this new approach to risk management, Carrel writes, "risk exposures and sensitivities do not merely rest on amounts and figures. Risk is a changing geometry, an adaptive complex system." In turn, the process of mitigating and managing risk becomes part of the "corporate culture, or a set of values and attitudes shared by all operating units within a firm," with risk clearly becoming "the people's business."

Diagnosis and Intervention

Questions have been asked, the negative and self-destructive behavior has been identified and assessed, and now, a full-scale intervention gets under way. This may sound like something out of reality television or a pop psychology demonstration, but in a risk-cultural sense it could be far more dramatic.

We are talking about a risk management/corporate operations intervention, taking place over a period of weeks or sometimes months, led by teams of executives overseeing multiple business units and designed to improve and fine-tune the risk culture of a global corporation, planned in concert with the global consulting firm McKinsey & Co.

When it happens – possibly in the aftermath of a major event showing evidence of a risk-culture breakdown, whether taking the form of fraud, a significant financial loss, security breach, operational emergency or over-leveraging – the project is executed by a SWAT team of executives or division leaders working alongside a key architect or risk culture leader. The team will actively oversee seven to 10 initiatives designed to effect change across the enterprise, including business activities such as how transactions are processed, how business is negotiated and relationships are handled; how employees are trained and rewarded – in short, the organization's day-to-day practices and business culture.

"In our view, a risk-culture intervention entails a number of hard process changes in the day-to-day operating environment that add up to big cultural changes, with all of it being reinforced at the top, by the CEO," says Cindy Levy, a senior partner in McKinsey's London office and a co-author of a white paper titled "Taking Control of Organizational Risk Culture."

Cindy Levy

Levy and McKinsey risk management specialists Eric Lamarre and James Twining concluded that factors that have led to material financial disasters in the corporate world in the past several years – including Deepwater Horizon, the Société Générale rogue trading scandal and the Enron Corp. implosion – have been largely related to flaws in the prevailing culture. More specifically, risk culture, or what McKinsey describes as the norms of behavior for individuals and groups in an organization, including a common set of standards that define its approaches to risk taking. Flaws in a firm's risk culture can allow various risks to take root and create serious vulnerabilities over time.

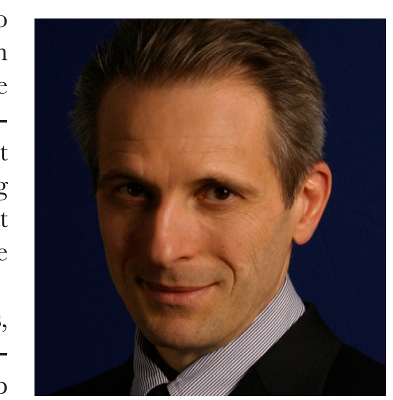
Wide Applicability

McKinsey's solution includes a model and tool kit for organizations to assess their risk cultures.

"Often, firms will tell us that they have done a lot to streamline risk; they have a new risk map and have loaded on excessive formal governance," Levy says. But on closer examination, they have not addressed behavioral issues and attitudes, and this is a fallacy when trying to correct cultural norms. Another big fallacy is that CEOs often believe they can master their company's risk culture by firing single bullets. "If I can just get the clawback problem solved," a CEO will say, or "if we institute better risk training," the problem will go away.

Levy maintains that such measures are no substitute for a formal governance program designed to assess and enhance a risk culture over time, coupled with an intervention program that takes a more comprehensive look at the prevailing culture with a view to instituting change in a host of areas. "The pitfalls that can occur often come from a lack of patience by senior leaders," Levy says.

Improving a firm's risk culture, Levy says, begins with the careful identification and categorization of risk-culture failures. To help this process along, McKinsey experts have designed a diagnostic approach to assess a given organization's vulnerability to such a failure. Developed in partnership with organizational psychologists, the diagnostic tool, available online, along with in-person interviews, can help to reveal risk-cultural "hot spots" in different business units, geographies or seniority levels.



Philippe Carrel

Visual Representation

In turn, both the survey results and interview findings can be analyzed and structured in the form of a heatmap (see graphic) to illustrate to management the cultural challenges and weaknesses that need to be addressed and areas of opportunity for interventions. These can include specific hot spots related to management practices, structure and governance processes.

In 20 detailed case studies of risk-culture failure, McKinsey experts have identified 10 critical, consistently present contributing factors. Those factors fall within four groupings that can indicate the principal risk-culture failure tendencies at a particular organization. Those four groups of indicators are: the transparency of risk at a given organization; the acknowledgement of risk; the responsiveness to risk; and the respect for risk.

This framework is particularly helpful, Levy says, because different firms in the same sector can have very different risk cultures, and when they fail, they will fail for very different reasons. For example, Levy notes that one bank's diagnostic may exhibit a lack of insight and overconfidence in old procedures, causing failure in its risk culture; another's culture problems may have more to do with its preoccupation with technical risk limits and a failure to look at risk holistically.

Although she concedes that a risk-culture assessment cannot cure all of a company's ills, it can help to build a stronger, more successful business better attuned to risk. According to Levy's research, the journey of risk assessment will foster a common language, a framework for describing an organization's risk culture, while providing managers with a concrete program for engaging and intervening in problem areas. In short, let the risk-culture interventions begin!

Katherine Heires, founder of MediaKat llc, is a freelance business and technology journalist based in the New York area. Her last Risk Professional *article was "Time to Feed the Beast," June 2011.*