Risk Culture in the Private Sector

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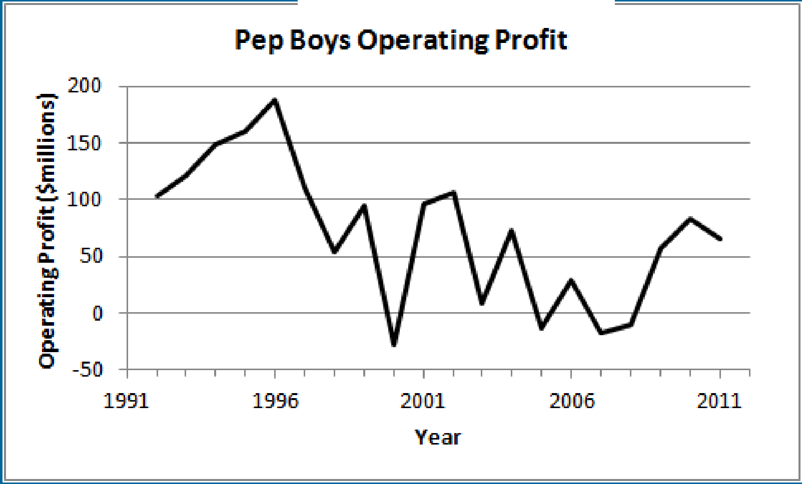
Outline

- Traditional risk management
- Enterprise risk management
- Defining risk culture in the business context
- Conflicting subcultures of risk and strategy mgt
- Research needs

Risk is uncertainty in progress toward strategic goals, e.g. profit, sales, employee happiness, carbon footprint

Performance volatility (risk)

- makes it harder to keep explicit and implicit promises to stakeholders*
- increases need for cash reserves
- draws regulatory scrutiny
- increases the frequency and severity of corporate crises



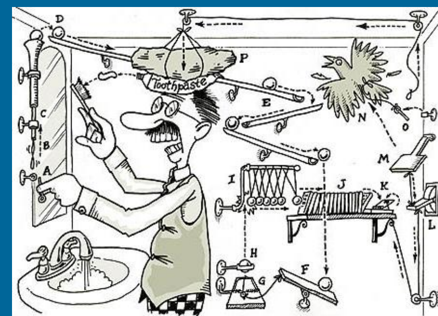
*In the business context, stakeholders are any group with a stake in the performance of your organization. They include shareholders, employees, customers, suppliers, regulators, and communities that host your facilities.

With which firm would you rather invest or contract?

Because of risk aversion, Firm B has higher shareholder value.

Some sources/drivers of risk in the private sector


New ventures

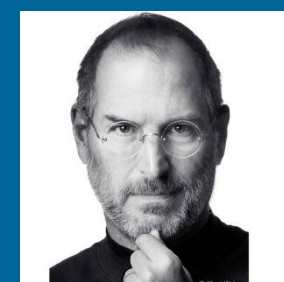


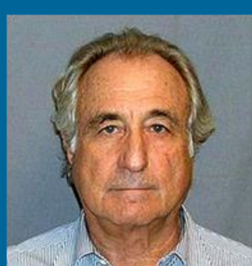
Product reliability


Accidents

Supply chain


Political events


Loss of key player

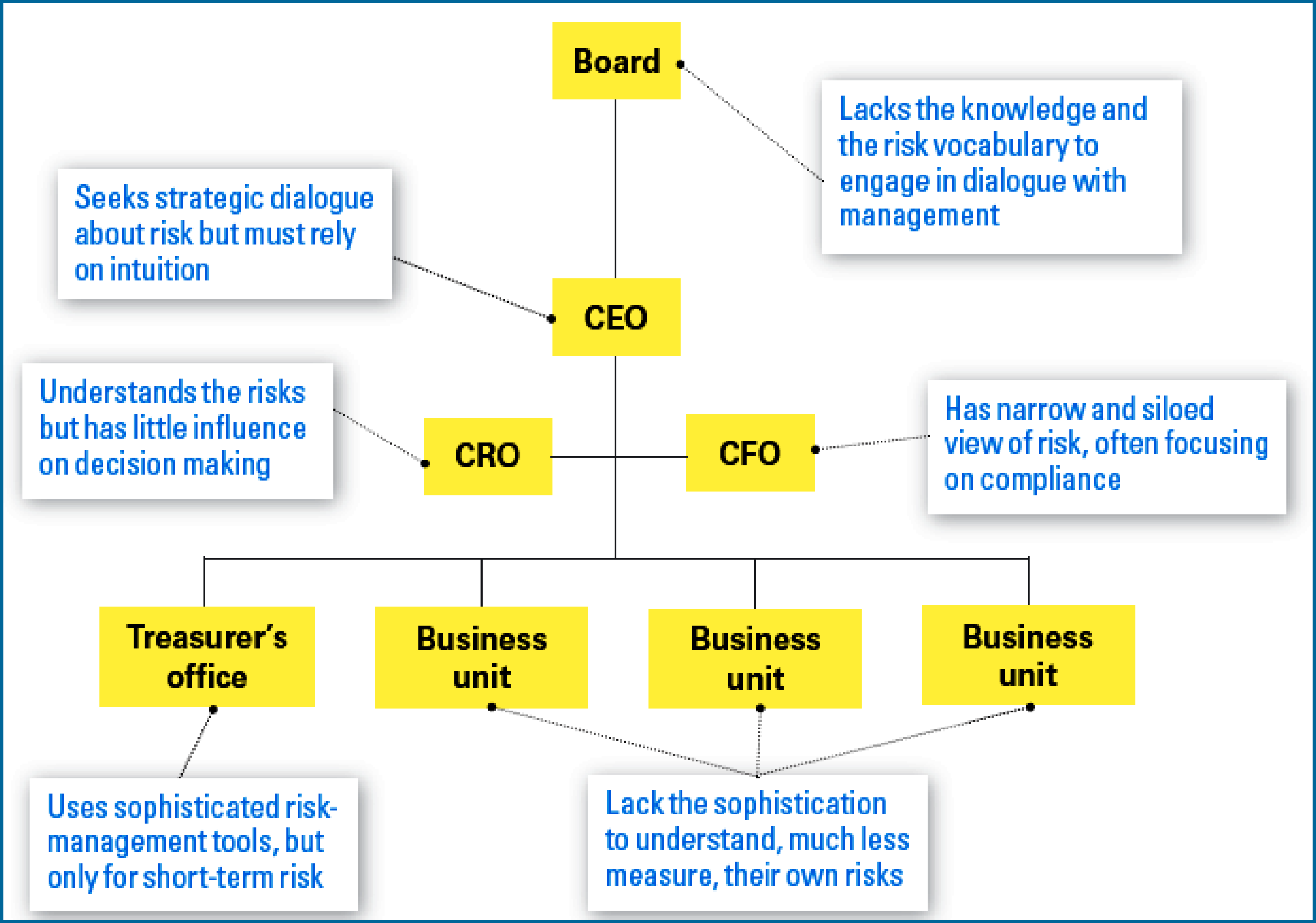

Fraud


IT failure


Prices and rates

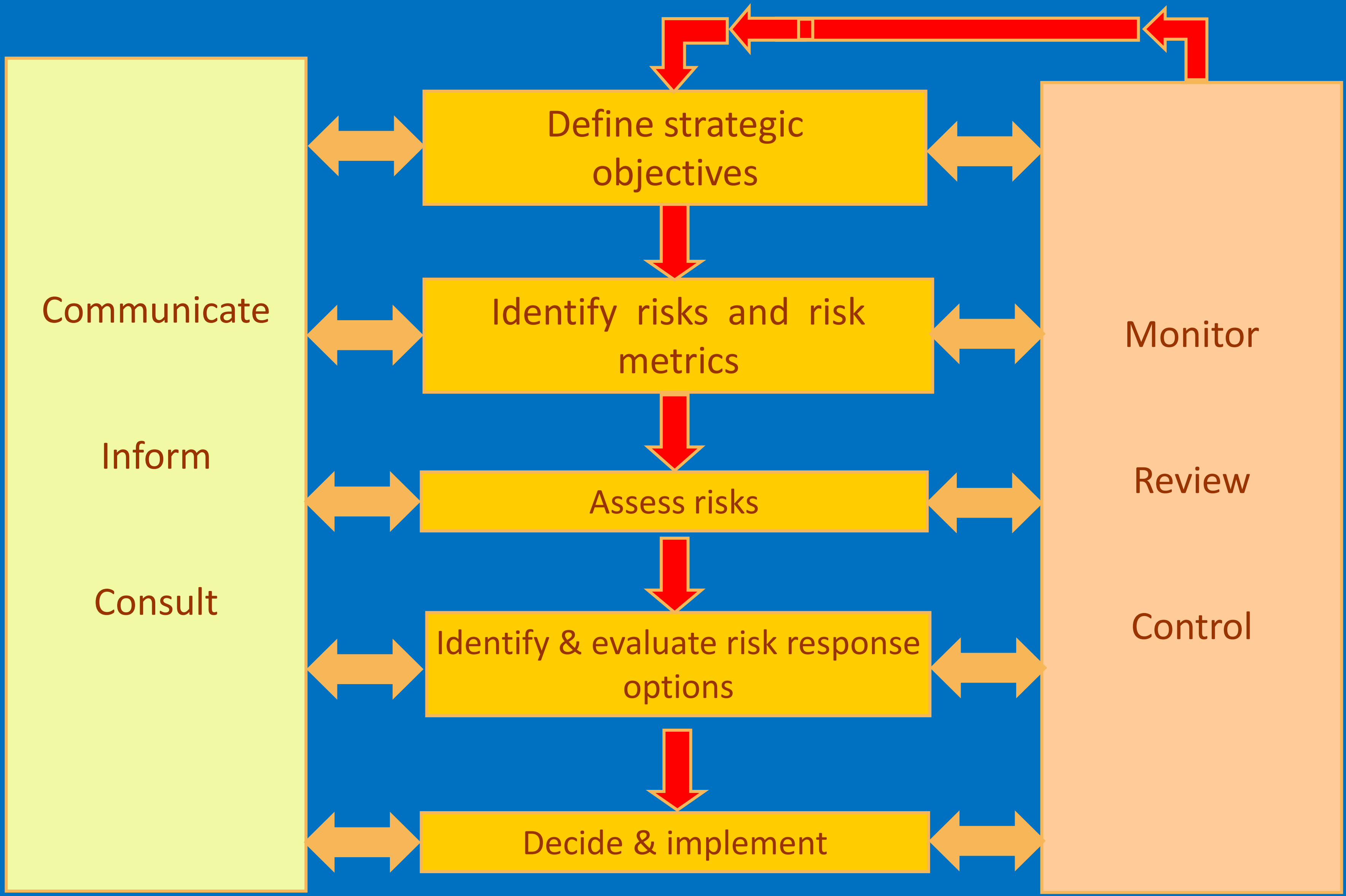
Traditionally, risk management decisions were uncoordinated.

Traditional organizational roles in risk management lead to compartmentalized and inconsistent risk-related decisions



From Buehler et al., *Harvard Bus. Rev.*, September 2008.

Integrated Enterprise Risk Management solves "silo" problem



Adapted from Australia/New Zealand Standard AS/NZS 4360:1999, "Risk Management."

Risk Culture

"The norms of behavior for individuals and groups within an organization that determine the collective ability to identify, understand, openly discuss, and act on the organization's current and future risks."

-Levy, Lamarre, & Twining 2010

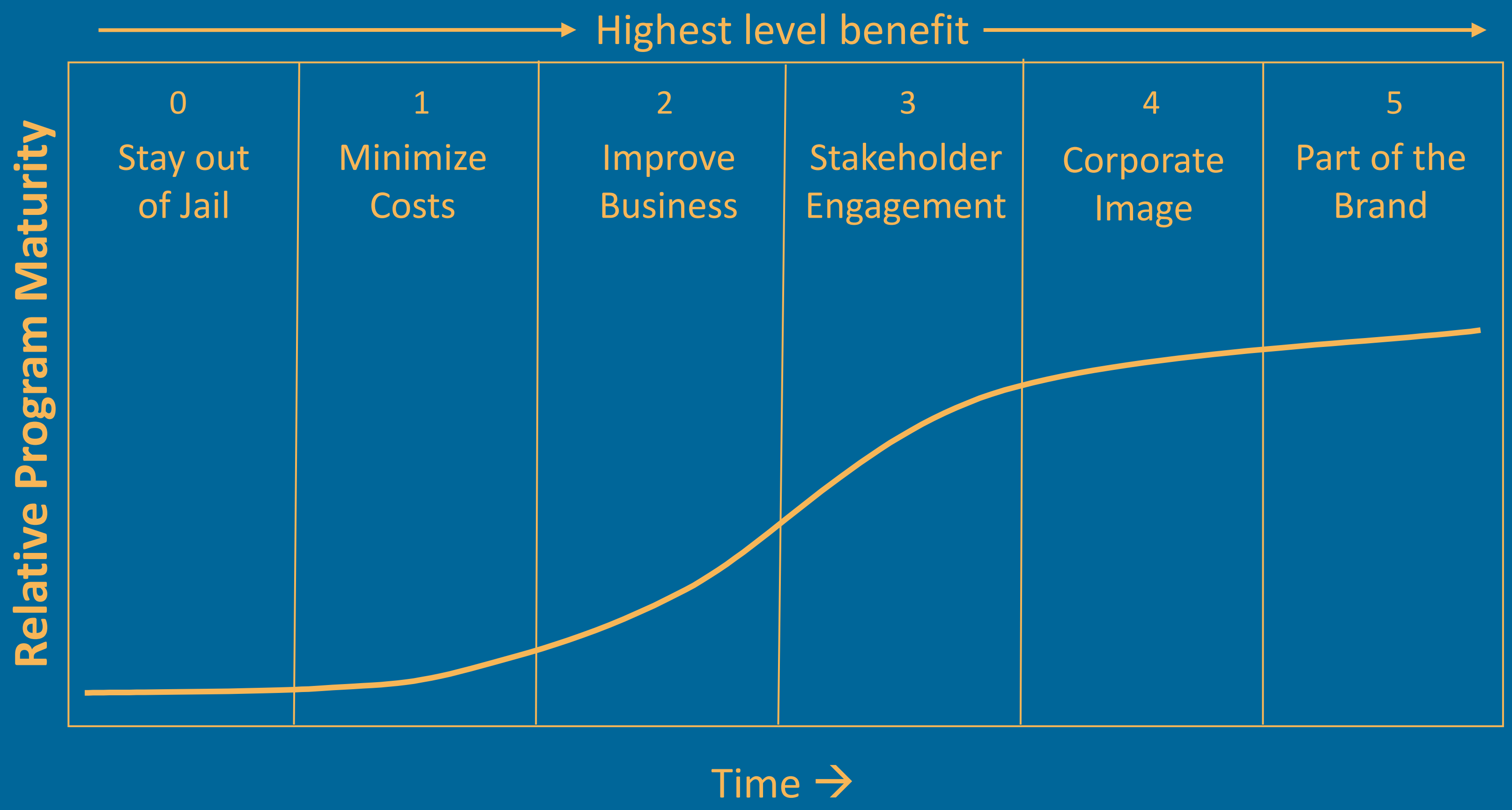
Ten Metrics of Organizational Risk Culture

(Banks 2012)

1. Leadership tone regarding risk
2. Governance processes relating to risk
3. Transparency on risk strategy, appetite, and exposures
4. Resources devoted to risk management
5. Technical risk skills
6. Decision making processes, timelines and success
7. Business and risk management relationship
8. Communications frequency and clarity
9. Incentive mechanisms related to risk-taking
10. Risk-related surprises

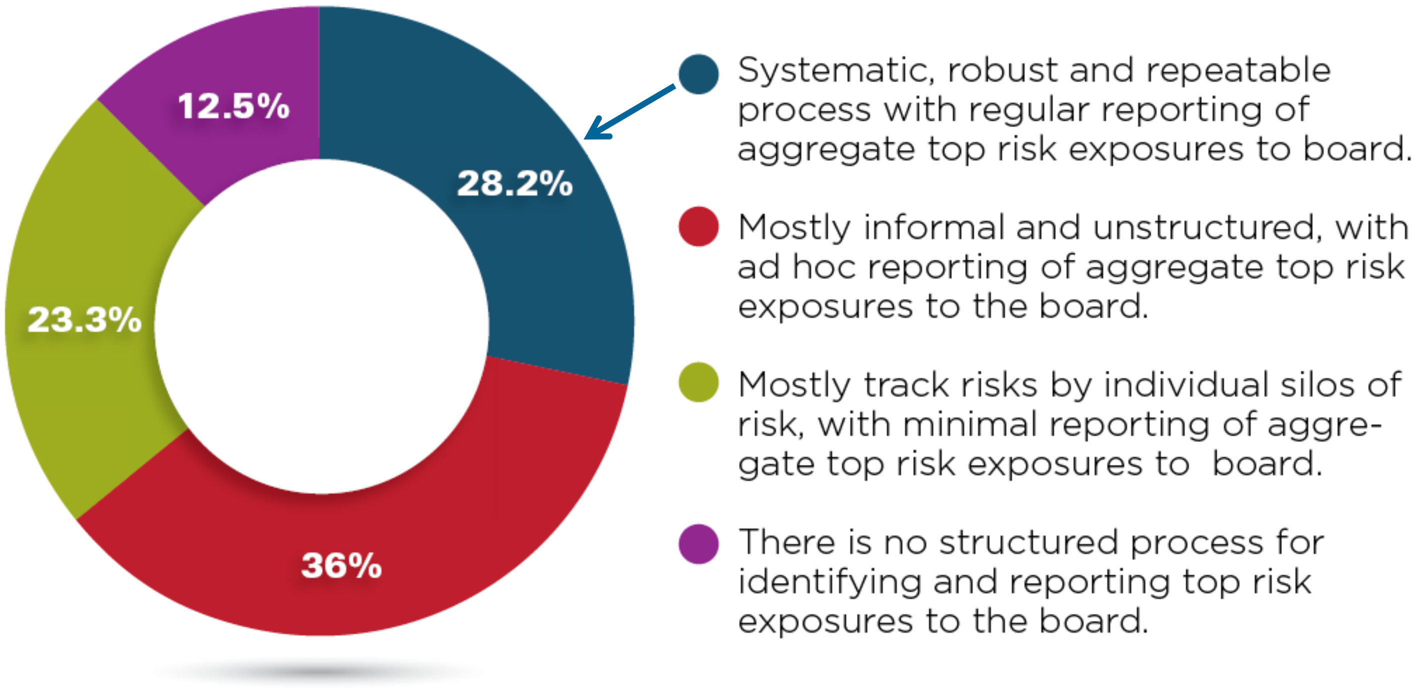
Evolution of a firm's perception of its risk management program reflects change in risk culture

(dela Torre, Oracle Governance, Risk, & Compliance Office, 2011)



Status of ERM adoption

Results from a 2010 survey of 460 mostly large US firms in diverse sectors



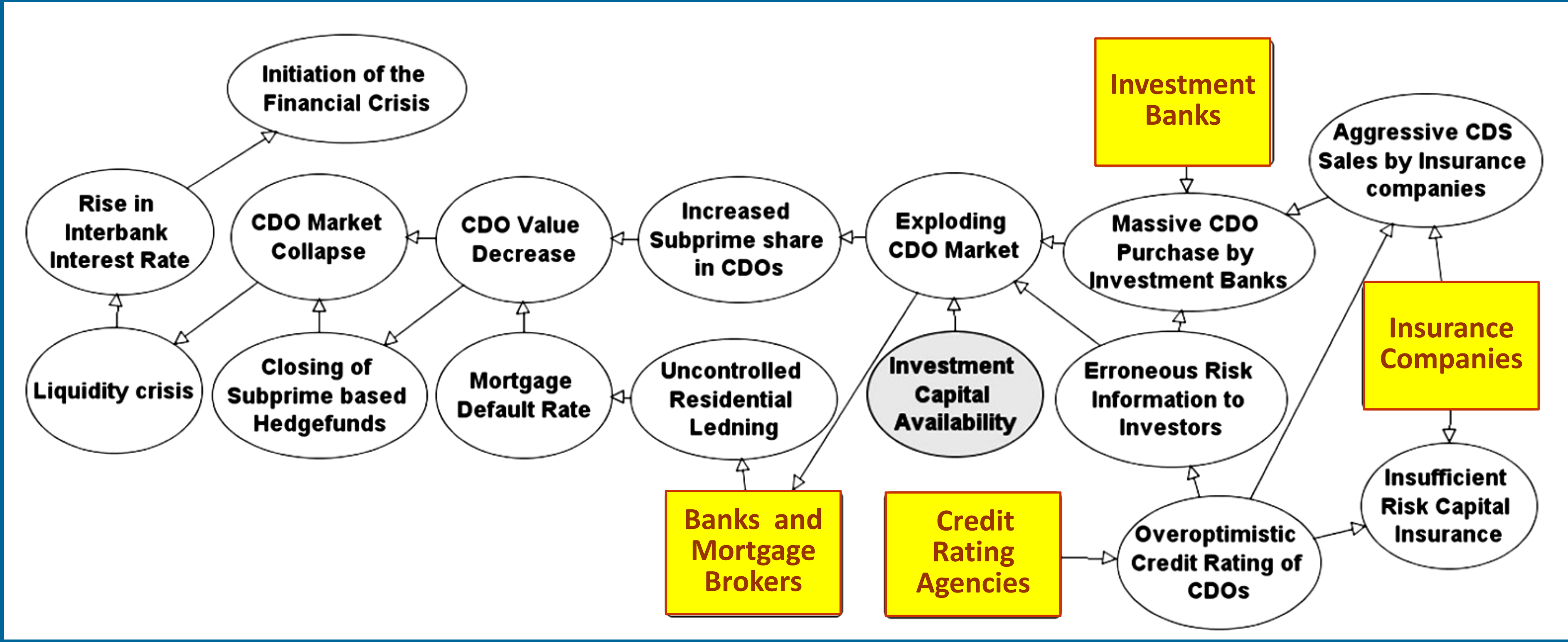
From Beasley et al. (2010) “COSO’s 2010 Report on ERM: Current State of Enterprise Risk Oversight and Market Perceptions of COSO’s ERM Framework”

Organizational Levels of Risk Culture in the Private Sector

Level of organization	**Example behavior**
Industry/Sector	Skepticism about info from outside the firm
Corporate	Level of board interest in risk
Division	Giving freest reign to high-risk high-return departments
Product	Pre-market testing
Department	Fraudulent reporting to make performance target
Project team	Realistic estimate of completion date
Individual	Personal risk aversion

Risk culture at the sector level: Organizations interact to cause the 2008 financial crisis

From Anderson et al (2012) Reliability Engineering and System Safety 105:3–12



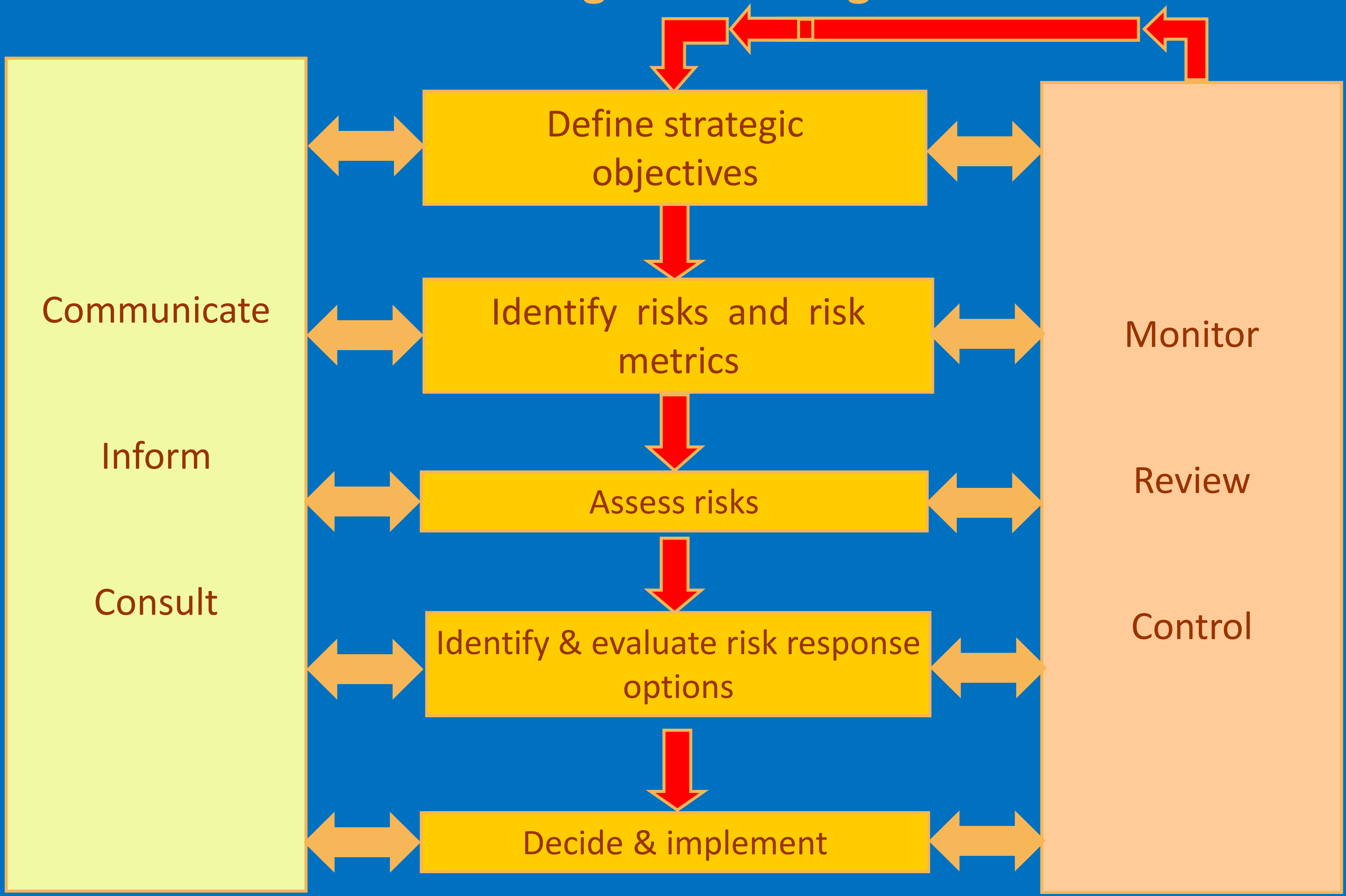
(CDO – Collateralized debt obligations, CDS-Credit Default Swaps)

Real decision making uses 3 orthogonal processes. Risk culture is shaped, in part, by which dominates.

DM Process →	**Thinking first**	**Seeing first**	**Doing first**
What is it	Define, diagnose, design, decide	Gather it all in. Incubate until insight crystalizes	Jump in. Try something. Learn about it. Decide whether to keep it.
Downside	Options looking for problems, feelings looking for decn situations to be aired. Uncertainty clouds best option.	Might wait a long time for insight to arrive. Is resulting insight practical?	Might waste time and money.
Best utilized	Established business systems	New products in existing business.	Diversification into new businesses.

Adapted from Mintzberg & Westley (2001) "Decision Making: It's Not What You Think," Sloan Mgt Review, Spring.

Does the dominant Enterprise Risk Management paradigm respect "seeing" and "doing"?



Adapted from Australia/New Zealand Standard AS/NZS 4360:1999, "Risk Management."

Risk Police Can Spoil the Fun

- Risk culture that is too aggressive squelches adventure.
- Crises caused by weak risk management can have global impacts and get lots of public attention. But the miracle app that never flew b/c risk managers killed it can be equally socially harmful. Yet that doesn't make the news.

Conflicting subcultures of risk and strategy
(Kaplan & Mikes 2012)

"Managing risk is very different from managing strategy. Risk management focuses on the negative—threats and failures rather than opportunities and successes. It runs exactly counter to the "can do" culture most leadership teams try to foster when implementing strategy. And many leaders have a tendency to discount the future; they're reluctant to spend time and money now to avoid an uncertain future problem that might occur down the road, on someone else's watch. Moreover, mitigating risk typically involves dispersing resources and diversifying investments, just the opposite of the intense focus of a successful strategy. **Managers may find it antithetical to their culture to champion processes that identify the risks to the strategies they helped to formulate**."

Coexisting (in harmony?)

Manage strategy risks separately

(Kaplan & Mikes 2012)

Category	**Example**	**Recommended Management Approach**
Preventable risks	Operations failures: supply chain, fraud, unsafe practices.	Make rules and follow them. (Compliance system)
External risks	Systemic risks: natural disaster, financial crisis, political instability	Stress testing, scenario planning. Prepare mitigation strategy.
Strategy risks	**Venture risk from new products, new markets, new regions, acquisitions, response to disruptive technologies.**	**Scrutiny by outside risk experts** **Strategy risk reported directly to CEO and BoD.**

Research Needs

- Studies of ERM benefits suggest a net positive effect on stakeholder value, but we need studies of the impact of ERM on innovation.
- What is the best organizational relationship between risk managers and strategy managers?
- Should risk managers be trained in strategy?

谢谢 ！