Brief

For those too busy:
The latest research, thinking
& news on growth pace and delivery
from around the world

Danger - smart executives at work: leadership and risk

Is it just banks where smart people make such poor decisions? Or can it happen anywhere?

As a wide range of experts, commentators and ordinary people have asked: how was it that smart executives made such remarkably poor decisions? There has been a rush of publications since the crash of 2008 on how why such dangerous risks were allowed in banks across the world. We looked through a range of material, over the last five years, to identify the consistent points of interest to any organisation.

Our sources have included material from London Business School and Harvard, work by McKinsey and PwC, articles in the FT as well as the iconoclastic and stylistically left-field book from Pablo Triana: *Lecturing Birds on Flying: Can Mathematical Theories Destroy the Financial Markets?*

What goes wrong?

Much more has been written on what tends to go wrong with risk management, than how to improve it and put it right. Economics and finance academic René Stulz identifies six ways that companies mis-manage risk:

1. ***Relying on historical data***: data does not predict what happens next - extrapolating from the past is dangerous if the future turns out to be different.
2. ***Focusing on narrow measures***: this can happen by focusing on what is easier to monitor or measure – for example by looking at short-term risk when the important ones are long-term
3. ***Overlooking knowable risks***: this includes ignoring risks not normally associated with a particular activity and those caused by markets dominated by a few big players
4. ***Overlooking concealed risks***: people responsible for incurring risks often do not report them – often deliberately, but usually unintentionally.
5. ***Failing to communicate***: there is little protection if those who know about, or monitor, or manage risks, do not tell others - including those leading or governing the business
6. ***Not managing in real time***: risks can change quickly and action is best taken quickly – staying current reducing risks.

Above all, most commentators suggest that the most common failing is simply to fail to escalate known issues.

Two main ways that risk increases across an organisation

To quote former US Secretary of State Donald Rumsfeld, "there are known unknowns, and there are unknown unknowns". Risk management is about how to approach both of these. As many experts have pointed out, a business risk is not a nebulous or mysterious thing. Risks are mainly created in one of two ways:

1. ***Continuing success breeds complacency***

   A repeatedly successful and long-standing way of operating or doing business can prompt increasing complacency. Although there may be no signs of problems to those at leadership level, it is only a matter of time before a problem arises. This usually means that some important and basic things that should be done are not being done, have been forgotten, or are no longer deemed necessary. This is often the case with the classic life-or-death health and safety issues which have resulted in everything from sunken ferries and derailed trains to exploding refineries and oil spills.

2. ***Potential gains from a new opportunity are too tempting to ignore***

   A new opportunity appears, or a major change is being planned and introduced, and there are misunderstood, unintended or unpredictable consequences. Or else it is decided that, despite being a new and unknown experience, the risks are outweighed by the gains. This was the case with the risks underlying the recent banking crisis, and is frequently the case with major business risk, such as a big acquisition. The ‘glory’ is just too tempting.

The route to better risk management: moving from less external responsibility to more personal responsibility

The studies suggest that there are three complementary approaches to risk management:

a. ***Formalisation:*** introducing or strengthening rules, procedures and decision-processes to judge and manage risk. This includes installing risk management roles, committees and ensuring that risk is a regular item on executive and board agendas

b. ***Externalisation:*** using expertise and seals of approval from outside. This includes bringing in auditors, regulators taking more hands-on interest, as well as the impact and intervention of credit-rating agencies and those who are influenced by them

c. ***Personalisation:*** pushing the responsibility for evaluating and managing risk onto those making and managing the actual decisions. This includes stronger requirements for monitoring, reporting and assessment for all leaders and managers.

Most commentators on the banking crisis suggest a need to focus less on externalisation and more on personalisation. They also agree that organisations should look for the answer to improving risk management within their organisation, more than looking for the next new external risk. The problem for banks was not sub-prime assets, it was the way they managed the risk of sub-prime.

Three ways to strengthen ‘personalisation’ of risk-management for leaders and managers

In looking at the switch from 'externalisation' to 'personalisation', the literature suggests three requirements:

1. ***High quality insight:*** How to ensure managers and leaders seek and use high quality, objective information, effective analytical tools and the ability and inclination to use it.
2. ***Personal accountability:*** An example from the way that all UK police are trained: when a routine incident escalates and becomes more serious, an employee of any rank can trigger a 'critical incident' approach, call together a cross-force group to pull together all information available and make a decision about how to react. This allows accountability, those in the know to act, and action based on insight.
3. ***Supportive culture:*** Those banks that survived the crisis better (Goldman Sachs and JP Morgan for example) are known for more team-based decision processes where debate and open and productive challenge are the norm.

   In a KPMG survey of 500 bank executives, 48% cited risk culture as a leading contributor to the credit crisis and felt that leaders are the ones who shape culture. One third said that leaders in their organisation had no training in risk management, and that other problems were:

   - no conscious tone set from the top
   - lack of clear and open communication about what is expected on risk and ethics
   - lack of incentives to support doing the right thing
   - failure to include risk issues in formal decision-making.

The role of the board – should it take a much broader, more integrated approach to risk?

Some commentators point out that there are dangers in putting risk into silos - and this includes the idea of Risk Committees. This does not mean these committees are a bad idea, more that they should support rather than replace the role of the whole board, and should be looking at risk from a complete business sense, not just a narrow technical sense.

With a wider, longer-term strategic perspective, the most important role a board can play is to be transparently and clearly interested in the all-round health of the company, and not simply its immediate financial health. A McKinsey survey of boards showed a good proportion wanted this broader agenda, including: market health, organisational health, operating environment health (regulators, public opinion and business partners), reputational health and operational health. One block to this is that companies do not have the processes in place to provide their boards with simple yet comprehensive reporting in these areas.

Good risk management requires many similar processes to good decision-making

The published material reminds us that the disciplines of effective risk management are quite similar to those of good decision-making in general. The use of the right evidence, a whole-system approach, robust challenge (in a collegiate environment), clear well-articulated conclusions and follow-through are all common to both.

(For our other *Briefs* on leadership team decision-making see: *Time alone and time together: getting you leadership team to make decisions*; and *Decision-making: how to avoid your leadership team acting like teenagers*.)

Above all - common sense, including moving from process and action

An AD Little survey showed that many companies who ticked all the boxes on 'risk management systems' did less well at actually managing risk – managing the process is clearly not the same as actually managing the issue. Above all, what is required is an all-round common-sense view.

Part of that is being focused on what you intend to do, and not just the analysis. If you live in Florida it will do little good wasting time regularly working out the risk of hurricanes. You need to have a plan for what you do when they happen. This means businesses spending more time on scenario planning (and becoming prepared and responsive) and less time on precise risk measurement.

Sources

Sources used for this article include: Birkinshaw, Jenkins: *Personalising risk management* (London Business School); Farrell and Hoon: *What is your risk culture?* (Business Week); Grant: *Risk management: Blue sky approach sought for improving early warning* (FT); Heffernan: *Dare to disagree* (TED talk by author of *Willful blindness*); Stulz: *Six ways companies mismanage risk* (Harvard Business Review); Triana: *Lecturing Birds on Flying: Can Mathematical Theories Destroy the Financial Markets?* ; *Identifying the next emerging risk*, and *Never again? Risk management in banking beyond the credit crisis* (KPMG); *View from the boardroom 2005 (McKinsey) Uncertainty tamed? The evolution of risk management in the financial services industry (PwC).*

