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GUEST EDITORIAL

How "Soft" Issues Can Cost Hard Cash and Top Jobs
And why risk managers need new skills

by Derek Atkins[1] and Anthony Fitzsimmons[2]

Risk management isn't new. It's been an evolutionary force beyond human memory. Communities of marmots[3] still keep watch for eagles, learn from experience and warn each other of possible danger as they roam steep alpine slopes (though they don't call it risk management). Ever since human communities began, members of *homo sapiens* have been wise to identifying risks, assessing their likelihood and potential impact before deciding whether to accept them, avoid them or mitigate them. The Romans went on to develop fire brigades, with the emperor Augustus adding fire watchmen as BC moved to AD. And as many readers know, the Phoenicians shared marine risks using contracts that can be seen as the forerunner of marine insurance.

For centuries, much of the expertise in managing risks resided in the great military and religious institutions, but the modern discipline of risk management as a systematic recognised process appeared after the Second World War. When civilians, who had been drafted into the military, returned to their jobs in 'Civvy Street', they began to apply some of the risk management ideas they had learnt during their service. Like many other aspects of management, it took root first in the U.S. before moving to Europe and beyond.

The high-risk industries (chemicals, pharmaceuticals, oil and gas) were early adopters and further developed techniques, often learning from the aftermath of disasters. However, it gradually spread to other industries, the major stimulus across all industries being the increase in insurance premiums in the mid-1970s when companies were forced to look for less expensive alternatives.

The next big change in risk management occurred in the 1990s when it started to become more corporate in scope rather than essentially operational, largely as a result of the advice of insurance brokers. Alternative Risk Transfer (ART) was developed to exploit the cheaper financing available in the capital markets; there was also rapid growth of captives and companies began to make more use of techniques such as business continuity and crisis management.

A recurring theme in risk management as it had been practised was coordination—or more specifically lack of it. Most companies had created a hotchpotch of plans, some overlapping and some conflicting. More seriously, some risks were ignored because they were nobody's specific responsibility. It was an attempt to address these issues that gave rise to the latest development, Enterprise Risk Management (ERM). From the early 2000s, some companies, particularly those in the financial services sector, adopted a more comprehensive enterprise-wide approach encouraged by stricter codes of corporate governance and a perception of an increasingly risky environment.

Like much else in risk management there is no universally agreed vocabulary and methodology. Various bodies have published standards but actual practice differs significantly from company to company. Nevertheless, the common denominators are the inclusion of corporate risks as well as operational risks in the same process, and the consideration of risk accumulations and aggregations. Some companies, but by no means all, apply ERM to opportunities as well as the traditional 'downside' risk. An essential element of ERM is strong coordination and it is common to give overall responsibility for this to a risk manager. A very senior manager might be chosen for this role and the title Chief Risk Officer (CRO) might be used. A recent survey implied that over 70 per cent of major financial institutions in the U.S. and Europe have chosen to appoint CROs. Some have CEO potential.[4] But many risk managers, particularly those outside financial services, are much less exalted than this, often sitting within the company's legal, internal audit team or CFO team. Risk management has come a long

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3 BBC (2008) *Science & Nature*, at http://www.bbc.co.uk/nature/wildfacts/factfiles/593.shtml.

4 For an example see A. Fizsimmons (2011) *Reputability—Reputation and Crisis Risk and Strategy*, at http://reputabilityblog.blogspot.com/2011/09/musical-chairs.html.

way, but *Roads to Ruin*[5] makes it clear that it has much further to go. The research investigated the origins and impact of over 20 major corporate crises of the last decade. Case studies were chosen to cover a wide range of types, from fires and explosions, product-related and supply chain crises to fraud and IT failures. They involved substantial, well known and generally respected organisations such as Coca-Cola, Firestone, Shell, BP, Airbus, Société Générale, Cadbury Schweppes, Northern Rock, AIG, Independent Insurance, Enron, Arthur Andersen, Railtrack and the UK Passport Agency, as well as some smaller firms.

The Cass team estimated their combined pre-crisis assets at over US$6 trillion, yet, seven companies faced bankruptcy. In 11 cases, the Chairman and/or CEO lost their job. 'Shareholder value' was destroyed on a prodigious scale, with shareholders of many companies completely or nearly wiped out. Most of the survivors suffered severe reputational and operational damage.

The report provides a rich source of lessons about risk, risk analysis and risk management, and it distils over a hundred specific 'lessons about risk'.

The Big Lessons

Much broader lessons emerged from the case studies. *Roads to Ruin* shows how many of the firms, despite their disparate industries and the different types of crisis, shared important underlying weaknesses which made them especially prone both to crises and to the escalation of a crisis into a disaster.

The Cass team eventually classified these underlying weaknesses into key risk areas that are potentially inherent to all organisations. Unrecognised, they pose a hidden but potentially catastrophic threat to any firm, however substantial; and unrecognised, the risks remain unmanaged. They make a daunting list.

1. **Board skill risks**—Limitations on board skill and competence, including that of Non-Executive Directors ('NEDs').
2. **NED control risks**—Limitations on the ability of the NEDs to effectively monitor and, if necessary, control the Executives.
3. **Board risk blindness**—The failure of boards to engage in important risks, including risks to reputation and 'licence to operate', to the same degree that they engage in reward and opportunity.
4. **Poor leadership on ethos and culture.**
5. **Risks arising from change and excessive complexity**.
6. **Risks arising from inappropriate incentives**—whether explicit or implicit.
7. **Defective communication** risks arising from the defective flow of important information within the organisation, including to board-equivalent levels.
8. **Risk of 'Glass Ceilings'** a specific communication issue arising from the inability of risk management and internal audit teams to report on risks originating from higher levels of their organisation's hierarchy.

These critical risk areas mostly relate to so-called 'soft' issues such as communications, ethos, culture, leadership and behaviour or to the skill of leaders. The origin of these risks is typically the top layers of the organisation. These are areas that are often neglected in business schools and hard to measure. They lie beyond the reach of traditional risk management techniques as they have evolved so far.

And for good measure, how is a risk manager to tell those above that they, their ethos, behaviour, leadership, strategy or lack of skill may be a serious risk to the enterprise? Assuming that he has the skills to identify the risks accurately, how can we expect a risk manager to "speak [such a] truth unto power"? As a good risk manager, he knows all too well that he is putting his own job at risk.

As Anthony Hilton, a highly respected City Editor, wrote,[6]

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5 *Roads to Ruin* is a Cass Business School research report for Airmic. The work was sponsored by Locktons and Crawfords. The report analyses the causes of recent corporate disasters, looking beyond the trigger risks to underlying causes. The Cass team was led by Professor Chris Parsons. Professor Alan Punter and the Authors were the team's other members. Copies of *Roads to Ruin* can be obtained at *http://www.airmic.com/roads-ruin-study-major-risk-events-their-origins-impacts-and-implications*. Copies of the free Executive Summary can be obtained at *http://www.reputability.co.uk/section.php/64/1/press_and_publications*.

6 A. Hilton (2011) 'Here's how firms can learn from Murdoch', Evening Standard (19 July), p. 38, at *http://www.reputability.co.uk/files/20110717_Anthony_Hilton.pdf*.

> "In essence, risk systems tend to be numbers-based, and cover potential hazards or current operations. They can cover hard data, technical know-how, systems and strategies. What they don't do is handle softer issues such as management style, employee motivation, shared values and corporate culture. They are hopeless at behavioural issues. So for that matter are male-only boards. There are suggestions a board with a strong female presence is far more likely not to be so blinkered." He continued, "…The trouble with accounting, performance measurement and risk control—and indeed the teaching of business schools—is that they treat companies as if they are mechanical. They assume broadly that they are machines which, for a certain level of inputs, will deliver a predictable level of output. But the greater truth, particularly in the modern era where talent is the big differentiator, is that companies are collections of people, and they are as much biological as mechanical."

In the age of social media, he might have added that the balance of power between the population and the establishment—whether government or corporate—has radically shifted in favour of the public. Through Mumsnet,[7] mothers persuaded Maclaren that it needed to treat U.K. baby-buggy owners with as much concern as their American sisters; and at another end of the spectrum, the Arab Spring was triggered and organised through social media. What Carl-Henric Svanberg unfortunately called "the small people"[8] can now coalesce overnight into a powerful cohesive force that few understand in advance.

Risk management needs to focus on its blind spots

The evidence is that these risks are potentially catastrophic, both by increasing the risk of a crisis manifesting and by exacerbating crises when they occur. When they materialised, these risks typically wrecked reputations and often the business too. Shareholder value was destroyed on a prodigious scale. But they don't appear in risk maps. It was also interesting to see how insurance was often of minor relevance to the losses that were suffered. This is not surprising since their nature puts these risks close to or over the boundary of uninsurability.

We believe these dangerous risks must now be drawn into standard risk management processes. The conclusion of *Road to Ruin,* with which we emphatically agree, was that four developments are necessary to deal with these risks.

- The scope, purpose and practicalities of risk management will need to be re-thought, from board level downwards, in order to capture these and other risks that are not identified by current techniques.
- The education of at least some risk professionals will need to be extended so that they feel competent to identify and analyse risks emerging from their organisation's ethos, culture and strategy, and from their leaders' activities and behaviour.
- The role and status of risk professionals will need to change so that they can confidently report all that they find on these subjects to board level.

These potentially catastrophic risks will remain unmanaged without a fourth change: boards—and particularly Chairmen and NEDs—will have to recognise the need to find and deal with them.

Drawing these sensitive areas into risk analysis and bringing them to the listening ear of boards won't just require new skills that are, as yet, not widespread among risk managers. Boards will have to be persuaded that delving dispassionately into what some see as their exclusive domain is helpful and desirable, not insubordination.

Readers with long careers in risk management know how its scope has evolved continually to adapt to new learning and the demands of the business environment. *Roads to Ruin* marks the start of the next stage of evolution, directing attention to risks emanating from boards and from corporate ethos, culture and behaviour. Whilst the whole community will face a steep learning curve, the best risk managers will find a future brimming with opportunity.

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For the full newsletter, please see *http://www.genevaassociation.org/PDF/Risk_Management/GA2011-RM50.pdf*

[7] *http://www.mumsnet.com/*.

[8] J. Herron (2010) 'BP vs. The Small People: Lost in Translation', *The Wall Street Journal* (17 June), at *http://blogs.wsj.com/source/2010/06/17/lost-in-translation-bp-vs-the-small-people/*.