GOVERNANCE

March 2017 Issue 273

Fit for purpose?

'At present, there is no effective means of appropriately punishing actions by directors that have a significant adverse impact on their shareholders, stakeholders or on society in general. Any sanctions must, of course, be proportionate and justified, and must distinguish between bad behaviour and poor decisions made in good faith. But that does not reduce the need for them.'

Chris Hodge

Rethinking reputational risk

'Once identified these risks are hard to discuss because they are "off limits". We humans operate under complex social conventions that include what anthropologists call "social silences": things people won't discuss because, as Gillian Tett put it, they are "*dull, taboo, obvious or impolite*". … As a result, these risks fester and incubate, unseen and unmanaged.'

Anthony Fitzsimmons and Derek Atkins

Content

Feature

Rethinking reputational risk

Anthony Fitzsimmons and **Derek Atkins** take a refreshing new look, based on extensive research, at reputational risk and how it can be managed.

Why do seemingly sound companies led by intelligent well-meaning leaders fail despite large, diligent risk management teams and regular board evaluations? After years of study, patterns began to coalesce when we were part of the Cass Business School team that wrote 'Roads to Ruin', the seminal report commissioned by Airmic. Working together at Reputability we learned more and the result is our new book: *Rethinking Reputational Risk: How to Manage the Risks that can Ruin Your Business, Your Reputation and You.*

A hypothetical example is a good place to start. A company announced that its profits had been overstated by £300 million. The board was stunned. Shareholders were furious as the share price plunged 30 per cent. The board commissioned an inquiry. A few weeks later, the answer emerged: 'The accounts team over-stated receivables'.

As recently as the 1980s, air accident investigations commonly concluded that the accident was caused by 'pilot error'. Stanley Roscoe, an aviation psychologist of the time described this conclusion as '*the substitution of one mystery for another*'. He thought aviation investigators could do much better. They did. Moving to systematic root cause analysis of errors led to an extraordinary improvement in flight safety. One key was persistently asking the classic two-year-old's question: 'Why?'

Why did the accounts team overstate profits? *Because they were always testing boundaries as they tried to increase profit*.

Why? *Because they believed the CEO wanted to maintain a steady increase in profits.*

Why? *Because they thought his self-esteem and bonus depended on steadily rising profits.*

Why? *Because the board didn't explore such unintended consequences of the bonus scheme or risks from the character of the leader they had recruited.*

Why? *Because the board lacked sufficient depth of people skills to ask questions about risks stemming from human behaviour.*

Such risks rarely appear in risk registers, though recent FRC rules mean that boards should be managing risks such as these and reporting on related Principal Risks. Nor does the value of reputation feature there, whether in terms of qualitative advantages or its contribution to enterprise value – easily 30 per cent to 40 per cent for an admired quoted company.

In writing our book we found many new insights by joining up lessons from our case studies, research and lessons from subjects such as anthropology, behavioural economics and complexity that sit in separate silos. The purpose of this article is to introduce our insights.

Let us begin with a question: what is 'Reputational Risk'? This has generated heat that has distracted from risks that matter. We cut through the arguments with a deceptively simple definition:

> *'Reputational Risk is the risk of failure to fulfil the expectations of your stakeholders in terms of performance and behaviour.'*

Much 'performance' risk is corralled by classical ERM. But our fundamental discovery was that important risks from individual and collective behaviour are not captured by classical risk management. We name the main (overlapping) risk areas: 'behavioural', 'organisational' and 'board' risks.

These risks are double-acting. They increase an organisation's vulnerability to crises by causing systemic weaknesses; and if a crisis occurs, they tend to tip it into a reputational calamity.

This hole in classical risk management does much to explain why, despite armies of competent risk professionals, the financial crisis was possible. Crises continue to emerge through this hole – adding to our library of case studies.

We came to realise that leaders are more important than most realise. Leaders know they matter because they set strategy, systems and all the drivers of behaviour in an organisation. At the summit, boards understand their great power to do good. Less recognised is the corollary: that power equally magnifies the consequences of their errors. This applies both to what they achieve and how they achieve it. Thus Lord Browne achieved great things at BP. But unrecognised risks emanating from board level led to the Texas City Refinery disaster.

It is difficult for insiders to see these risks because cognitive biases prevent us from seeing our own weaknesses as clearly as outsiders can. Since their root causes can often be traced to leaders, they are dangerous to investigate let alone report on even to peers – though few risk professionals have the skills to find them because classical risk education doesn't yet go there.

Once identified these risks are hard to discuss because they are 'off limits'. We humans operate under complex social conventions that include what anthropologists call 'social silences': things people won't discuss because, as Gillian Tett put it, they are '*dull, taboo, obvious or impolite*'.

As a result, these risks fester and incubate, unseen and unmanaged, often for years. In the meantime leaders understandably believe all is well. The truth is that they are sitting on a time bomb with a dodgy clock, 'protected' by good luck. Few question the role of luck in seeming success; and when luck runs out, leaders are stunned to discover that 'everyone' – but them – seemed to know what had been going on under their noses.

While luck persists, these systemic risks manifest in minor mishaps and near misses. These are valuable sources of intelligence. Aviators capture and analyse them, using the resulting insights to find and fix failings before they cause crashes. Elsewhere, they are missed, ignored or covered up; and that clock ticks on.

The creativity of the human race makes the range of behavioural, organisational and board risks vast, but we will sketch a few areas with a focus on leadership issues, though risks such as these and many more appear at all levels. Our book provides much more detail.

A fundamental risk is inadequate diversity of skill, knowledge, experience and perspective among those who lead at all levels including the board. BP was severely criticised both for appointing a head of refining with no prior experience of running refineries; and for having a board with insufficient experience of safety operations. Few boards seem to have sufficient understanding of how heuristics and biases affect their perceptions, behaviours and decision-making – and those of others.

Ineffective challenge is a recurring theme. Leaders need constructive challenge but many, especially the charismatic and the dominant, don't get it. In the aftermath of the Texas City disaster, one kindly commentator wrote that Lord Browne lacked 'honest feedback': who would challenge the 'Sun King'?

Organisational complexity and internal silos cause sclerotic internal communications. Such dysfunctionality is one reason why leaders find that 'everyone' but them knew what was wrong well before disaster struck.

Leadership character is a source of risk that deserves far greater attention. Two weaknesses recur regularly. Some leaders show insecurity or dominance without the self-confidence and humility to welcome challenge and contradiction. Among their peers, subordinates and non-execs, we have seen a lack of courage to challenge effectively. We once asked a head-hunter why people with professional forensic skills, such as academics, lawyers and journalists, were rare among non-execs. We were told that chairmen dislike such people because they are prone to ask questions that are difficult to answer. So head-hunters don't propose such people unless asked.

Most boards try to set tone from the top. They fail when their carefully crafted good intentions are undermined by conflicting messages: behaviour unnoticed by them that doesn't match their words; and pronouncements that seem at odds with the leader's character.

Much can be said about incentives. Explicit incentives such as bonus schemes may have unintended consequences. Providing bonuses gave the PPI scandal its scale – £40 billion so far.

But incentives can be behavioural too. A superior who reacts tartly to bad news provides an incentive to delay telling them unwelcome news. '*Bring me solutions not problems'* is another example that has left leaders stunned when truth finally emerged.

Boards' mistakes can be devastating, so extending management of risks such as these to board level is the top priority. This is doubly so because any attempt to tackle these risks below board level without visible action at the top will undermine the effort.

The process should begin with the board. Education for the leadership team is the best place to start, an exercise requiring tact and, as the FRC reminds us, real expertise. A new kind of board evaluation is required to find these risks because classical evaluations don't go there. Expertise is essential of course, but it is vital that it is led by specialists who can see board risks as only outsiders can and, as the FRC recognises, have no fear of, or incentive to duck, explaining what will sometimes be uncomfortable truths to leaders so they can internalise and deal with them.

In parallel, the board should develop the existing risk team and systems to find and fix these risks throughout the organisation. New skills will be needed. As the FRC emphasises, risk teams must also be given clear authority, in practice from chairman and CEO, to follow these risks wherever the trail leads with no fear of retribution.

Here too, at least in the first instance, it is crucial to draw in outsiders trusted both to help see what outsiders can see given insiders' knowledge; and to help explain any uncomfortable truths to leaders.

Our book will help you achieve these goals. We explain how and why respected organisations fail, illustrating what we say through eight case studies. We explain how to tackle these

Continued on page 12

GOVERNANCE
www.governance.co.uk

Subscription form

Please complete this form and send by mail to:

**Subscriptions Department Governance Publishing and Information Services Ltd
The Old Stables, Market Street,
Highbridge, Somerset TA9 3BP, UK**

**Tel: +44 (0) 1278 793300
Email: info@governance.co.uk
Website: www.governance.co.uk**

(Please tick one)

- ☐ Yes! I would like to subscribe to Governance for one year
- ☐ Or, save with a 2 year subscription

Governance international subscription costs:

	£UK	Euro	US$
1Yr	325	450	490
2Yr	585	790	855

Governance can accept cheques in other currencies but an administration fee of £15 will be charged.

☐ I enclose a cheque/bankers draft for	
Currency	Value
☐ Please invoice me	
Specify currency:	
Order reference:	
Title:	
First name:	
Surname:	
Position:	
Company/Organisation:	
Address:	
Postcode:	
Email:	
Tel:	
Fax:	

Continued from page 11

risks by developing your existing systems. And we have laced our book with almost 200 questions and challenges to keep you thinking as you read.

With diligence you should achieve our aim: you will not join our library of case studies.

Anthony Fitzsimmons and Derek Atkins are authors of 'Rethinking Reputational Risk: How to Manage the Risks that can Ruin Your Business, Your Reputation and You'.

You can order the book with a 20% discount here: www.koganpage.com/reputational-risk using the discount code PBLRRR20.

You can find reviews in the Financial Times and Spear's Magazine here: http://tinyurl.com/RRR-Reviews

What our subscribers say

'Governance is a useful means of keeping up to date on developments in a field which is assuming greater importance by the day.'

'Governance is the leading monthly publication covering major corporate governance issues. A most valuable source of information for investors, financial advisors, corporate board members and executives.'

Index

Designed and printed by
WithPrint
Riverside Studio, Gills Lane, Rooksbridge, Somerset, BS26 2TY

ISSN 1358-5142

Governance Publishing and Information Services Ltd
The Old Stables, Market Street, Highbridge, Somerset TA9 3BP, UK
Tel: +44 (0) 1278 793300
Email: info@governance.co.uk Website: www.governance.co.uk